AltaGas
utility group

2006 Annual Report

Our Investments

AltaGas Utility Group Inc. is a niche player in the Canadian utility marketplace. Through our solid investments, AltaGas Utility Group Inc. distributes natural gas to over 65,000 customers in three Canadian markets: Alberta, through AltaGas Utilities Inc.; Nova Scotia, through Heritage Gas Limited; and the Northwest Territories through Inuvik Gas Ltd. These regulated utility companies represent a stable, long-term business model with a diverse customer and rate base and significant growth opportunities.

INUVIK GAS LTD.

Northwest Territories

Percent ownership	**33.33**
Employees	**8**
Customers	**801**
Pipeline	**47 km**
Service areas	**Town of Inuvik, Northwest Territories**

ALTAGAS UTILITIES INC.

Alberta

Percent ownership	**100**
Employees	**164**
Customers	**63,532**
Pipeline	**19,700 km**
Service areas	**More than 90 communities throughout Alberta**

HERITAGE GAS LIMITED

Nova Scotia

Percent ownership	**24.9**
Employees	**33**
Customers	**733**
Pipeline	**138 km**
Service areas	**Currently servicing areas in Dartmouth, Amherst and Cumberland County, as well as the Halifax International Airport**

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AltaGas Utility Group Inc.

AltaGas Utility Group Inc. (Utility Group) offers stable, long-term earnings to shareholders. At the end of 2006, we held investments in three significant Canadian utility companies: AltaGas Utilities Inc. (AUI), Heritage Gas Limited (Heritage Gas) and Inuvik Gas Ltd. (Inuvik Gas). Each of these companies fills a niche in the marketplace and offers a combination of stability and long-term growth potential.

ALTAGAS UTILITIES INC.

Headquartered near Edmonton in Leduc, Alberta, AUI has been providing natural gas service to customers for more than 50 years. Today AUI serves almost 64,000 customers – primarily residential, rural and commercial, with an infrastructure of approximately 19,700 km of distribution pipeline. Its business is geographically diversified in more than 90 small communities throughout Alberta. AUI serves approximately six percent of Alberta natural gas distribution customers.

Growth opportunities in AUI's business are largely defined by new demand in its service areas, combined with expansion opportunities within its franchise areas and potential acquisitions.

HERITAGE GAS LIMITED

Heritage Gas is based in Dartmouth, Nova Scotia and was established in 2002 to obtain and operate a full regulation class natural gas distribution franchise for Nova Scotia. The franchise gives Heritage Gas the exclusive right to distribute natural gas to all or part of six counties in Nova Scotia, including the Halifax Regional Municipality. Since its inception, Heritage Gas has expanded its service area in Nova Scotia to two communities and to the Halifax International Airport.

Heritage Gas offers strong growth potential as the company expands its service area and customers convert to natural gas from other, less efficient or less environmentally friendly fuel sources.

INUVIK GAS LTD.

Inuvik Gas is the first Canadian commercial natural gas development project north of the Arctic Circle. It has the exclusive franchise for natural gas service in the Town of Inuvik, NWT. Since 1999, Inuvik Gas has provided residents and businesses in the Town of Inuvik with a secure supply of natural gas heating at lower cost than diesel fuel shipped from Edmonton. In seven years, Inuvik Gas has grown to serve more than 70 percent of the Town of Inuvik's heating demand.

The conversion of larger commercial customers to natural gas is a growth opportunity for Inuvik Gas. Further growth is likely, due to economic activity associated with the proposed Mackenzie Gas Project. We expect that initially growth will lead to more services off the existing distribution system and then to expansion of the system.

Future Growth

Utility Group is positioned for growth. In addition to organic growth in our current franchise areas, we pursue opportunities to invest in high-quality utility companies with long-term, stable returns.

President and Chief Executive Officer's Message

AltaGas Utility Group Inc.'s first full year of operation as a small, publicly traded Canadian utility was an active and productive one. In 2006 we invested more capital in our three operating businesses than we expected, due to opportunities created by Alberta's buoyant economy and the continued expansion of our gas distribution systems in Nova Scotia. Our net income was also higher than anticipated, as the impact of lower deliveries due to warmer than normal weather was offset by lower than expected expenses. Our performance, although better than expected, is not fully reflected in our stock price, and we continue to trade at price to earnings multiples which are low for utility businesses of comparable value.

2006 RESULTS

Our net income of $4.2 million, or $0.52 per common share, was slightly higher than we anticipated it would be. The negative impacts of warmer than normal weather across Canada and regulatory decisions that affected AUI were more than offset by lower than expected operating, administrative and income tax expense, in combination with strong customer growth in Alberta and Nova Scotia.

At the end of 2006, Utility Group's operating companies and its 205 employees had serviced more than 65,000 customers and delivered 24.4 Petajoules of natural gas through almost 20,000 km of pipe. A more detailed discussion of our results and comparative information for our operating businesses is provided in the Management's Discussion and Analysis that follows.

DIVIDEND

Utility Group began paying dividends to our shareholders in April 2006. Our yield of under 2 percent in 2006 is, by design, at the lower end of the range of yields provided by our utility peers. We have chosen to retain a significant portion of our cash flow to reinvest in the build-out of the Heritage Gas distribution system and to grow Utility Group through acquisitions. Confidence that our businesses will continue to benefit from steady growth has led the Board of Directors to increase the quarterly dividend to shareholders by 17 percent, or $0.005 per share, from the $0.03 per share dividend declared in each quarter of 2006. A dividend of $0.035 per common share, payable on April 16, 2007 to shareholders of record at the close of business on March 30, 2007, was declared on February 26, 2007.

GROWTH

Utility Group's objective is to grow the company. In 2006, as expected, that growth came organically from our three natural gas distribution businesses. Since Utility Group's regulated businesses are allowed to earn a return on the investments in their rate bases, growing those rate bases to service new customers creates the opportunity to grow net income.

AUI is a mature, Alberta-based natural gas distribution utility and the largest of Utility Group's businesses. The continuing strength of the Alberta economy in 2006 drove higher than historical levels of subdivision growth and customer connections in AUI's service areas. Two years ago, AUI experienced what was then considered to be a year of exceptionally strong growth, with 1,376 new service applications. In

▶ **Organic growth in 2006 from AUI and Heritage Gas**

▶ **Rate base growth creates the opportunity to increase net income**

2006 AUI received 2,989 applications for service, more than double the number of applications received just two years earlier. Nearly 2,000 new applicants for service were connected in 2006, more than 50 percent of which were in the Leduc service area in the vicinity of the Edmonton International Airport. As a result of the large number of applications received late in the year, AUI entered 2007 with more than 1,000 applications for new service awaiting installation.

At Heritage Gas, the number of connected customers and customers committed to converting to natural gas but not yet connected doubled. Billed revenue tripled from 2005. We now service customers in Dartmouth, at the Halifax Airport and near the New Brunswick border in Amherst and Cumberland County. If the required level of commitment to take natural gas service is achieved in Halifax, Heritage Gas plans to build a natural gas pipeline across the Halifax Harbour in 2007. This pipeline will connect the Dartmouth distribution system to a distribution system to be built on Peninsula Halifax, allowing Heritage Gas to begin serving the area of Nova Scotia with the highest population and gas-load density.

Since Heritage Gas is still in its start-up phase, growth rates measured in relation to its small base may seem to overstate the impact on Utility Group. However, we expect that growth to continue, particularly once the Halifax Harbour is crossed with a Heritage Gas pipeline. The Heritage Gas contribution to Utility Group's consolidated rate base is expected to increase from 7 percent at the end of 2005 to 14 percent by the end of 2007.

The Inuvik Gas customer base grew 6 percent in 2006, as we began serving new subdivisions and converted commercial businesses from diesel fuel to natural gas.

Growth in service sites in Utility Group's businesses contributes to rate base growth. AUI's net rate base increased by 5.5 percent in 2006, to $97.4 million. This rate of growth exceeded the average annual growth rate of 2.3 percent for the preceding five years. The Heritage Gas rate base increased by 80 percent in 2006, to $51.1 million. This high growth rate is indicative of the greenfield nature of the Heritage Gas business.

Utility Group's three businesses have applied to their regulators for approvals to grow consolidated rate base by approximately 11 percent in 2007, a higher rate of annual growth than has been the historical norm. Success in obtaining regulatory approvals of these rate base forecasts will create the opportunity to realize a similar growth in regulatory net income. There are also opportunities to grow rate base beyond the forecasts reflected in the applications. For example, AUI recently won the right to deliver gas to an oil upgrading plant outside of its franchise area and will invest $1.3 million to build these facilities. We will continue to pursue opportunities to grow our natural gas distribution businesses and look forward to a busy 2007.

With respect to growing Utility Group through acquisitions, I spent a significant amount of time in 2006 evaluating potential acquisition opportunities, none of which would have provided accretive shareholder value.

▶ New distribution customers will lead to a busy 2007

▶ AUI forecasts more than 7.6% net rate base growth

REGULATORY MATTERS

The returns available to shareholders of a rate of return-regulated utility are set by regulators in the jurisdictions in which the utility has its franchises. In 2006, considerable effort went into cost of service and rate of return applications to ensure that our shareholders are fairly compensated for their investment.

While it is common for at least one of our businesses to file a major regulatory application during a given year, in 2006 all three of our business did so. This required a considerable dedication of time by the management of those businesses and, in some cases, by the management of Utility Group. These applications are important to the shareholders of Utility Group because they set precedents that may affect the ability of Utility Group's current businesses to recover their costs and to deliver the desired returns to shareholders in future years.

AUI's regulatory agenda was particularly busy in 2006. Along with a number of routine filings, the year included Compliance and Phase 2 filings related to AUI's 2005-2006 General Tariff Application and a 2007 General Tariff Application Phase 1 filing. AUI also filed a Review and Variance Application with respect to the decision it received on its 2005 Debenture Application. This decision resulted in a cost of debt that was 161 basis points lower than we had applied for and almost 200 basis points lower than the rate for the debt that was replaced. We believe that our arguments with respect to regulatory principles and new evidence we provided regarding the debt financing options available to AUI, and the true cost of those options, provide sufficient justification for the Energy and Utilities Board to vary its decision in favour of AUI. We hope to know by the end of the first quarter of 2007 whether or not the EUB will hear AUI's application.

Heritage Gas filed a General Tariff Application in September, two years before the end of the 2004-2008 test period. The Nova Scotia Utility and Review Board rendered a favourable decision in December, extending the test period to 2011, affirming the current capital structure, extending the recovery for the regulatory deferral account and approving an annual increase of 2.5 percent in Heritage Gas rates over the five years beginning in 2007.

Inuvik Gas increased its rates effective October 2006. This increase has been challenged by the Town of Inuvik, as is permitted under Inuvik Gas' market-based regulation. Discussions continue with the Northwest Territories Public Utilities Board and the Town of Inuvik regarding this challenge. While we cannot predict the outcome, we do not anticipate any material impact on Utility Group's bottom line.

PEOPLE

I believe that the high quality of the employees working under the Utility Group umbrella is a key driver of shareholder value. Throughout 2006, the employees of our three businesses met the challenge of rapid growth, connecting almost 2,400 new service sites. While tackling this growth, they have maintained an enviable safety record, and incorporated improved operational, financial and environmental controls. Through our employees, we continue to provide outstanding customer service, as evidenced by formal and informal feedback from our customers.

In 2006 Lorne Heikkinen retired after 13 years as President of AUI and was replaced by Earle Tuele. With more than 27 years of experience at AUI and

In 2006 our employees met the challenges of rapid growth

Ability to fund growth through cash flow, credit, and access to debt and equity markets

its predecessor companies, Earle has provided the strong foundation that has allowed him to excel in leading the AUI team, as I anticipated he would. We thank Lorne once again for the strong team he built as his legacy.

At the Utility Group level, Jim Leonidas joined us on December 4th, replacing Debbie Stein as Chief Financial Officer and Corporate Secretary. Jim has a strong business, financial and utility background that will serve us well as we continue to grow Utility Group's businesses and make key acquisitions. I thank Debbie for being with us for the start-up and first year of operations of Utility Group. Her contribution, pragmatic attitude and attention to detail were appreciated.

Over the last year the Board of Directors has provided oversight, guidance and advice that was much appreciated. Their in-depth experience in the Canadian energy industry was valuable as we evaluated acquisitions, business growth and regulatory impacts. I am pleased that they have all agreed to stand for nomination as ongoing Directors at our Annual General Meeting on April 18, 2007.

OUTLOOK

Utility Group is expecting another busy year for regulatory activity in 2007, as the various applications I referred to earlier are dealt with by the respective utility regulators. We expect Utility Group's three operating businesses to continue growing at faster than historical levels. In its 2007 General Tariff Application, AUI has forecast a 7.6 percent growth in net rate base. Heritage Gas' 2007 capital expenditures are forecast at nearly $23 million, as it continues to execute its strategy of obtaining customer commitments sufficient to meet economic targets prior to undertaking expansion of its systems. Although Inuvik Gas' business is expected to continue to be profitable, no major capital additions are forecast for 2007.

As I said earlier in this letter, the Utility Group management team welcomes the challenge to grow the business, both organically and through acquisitions of infrastructure-based utility businesses. We will continue to evaluate acquisition opportunities as they present themselves, and will aggressively pursue those that we anticipate will increase shareholder value. Utility Group is well-positioned to fund growth as a result of steady cash flow from operations at AUI and Inuvik Gas, its strong balance sheet and its access to credit, debt and equity markets.

In 2007, we will also continue to participate in and influence matters that are important to our industry through our engagement in associations, business relationships and community involvement.

In closing, I would like to thank the Board of Directors, our employees and our shareholders for their support and confidence. I look forward to growing this business in 2007.

Patricia M. Newson
President & Chief Executive Officer

Corporate Governance

As members of the Board of Directors of AltaGas Utility Group Inc. it is our responsibility to ensure that the interests of shareholders and other stakeholders are properly represented. To that end, the Board of Directors has assumed responsibility for stewardship of Utility Group and has developed standards and procedures for its operations that meet high standards of governance. We will regularly review Utility Group's activities with a view to ensuring its business affairs are conducted appropriately, with the honesty, integrity, transparency and accountability that shareholders expect. We are committed to directing the activities of Utility Group to those high standards.

The annual meeting provides Utility Group's executives with the opportunity to communicate goals and strategy to shareholders. The meeting offers shareholders the chance to hear first-hand from management and to understand Utility Group's strategy for seeking to continually increase shareholder value and grow the business. The Board of Directors and Utility Group's management team encourage you to attend the annual meeting either in person in Calgary or through the live webcast that can be viewed at www.altagasutilitygroup.com. The annual meeting will be held at 3:00 p.m. MDT on Wednesday, April 18, 2007 in the Royal Room at the Metropolitan Centre located at 333-4th Avenue S.W., Calgary, Alberta.

On behalf of the Board of Directors:

David W. Cornhill
Chairman of the Board

Utility Group believes that good governance improves performance and benefits all shareholders. Utility Group is committed to high standards of governance. The following is a summary of Utility Group's governance practices. A more detailed description of Utility Group's practices can be found in its Information Circular, which will be available on the SEDAR system at www.sedar.com.

STATEMENT OF GOVERNANCE PRACTICES

Mandate of the Board

The Board of Directors of Utility Group exercises overall responsibility for the management and supervision of Utility Group's affairs. This includes the appointment of the President and Chief Executive Officer and senior officers of Utility Group, approval of their compensation and monitoring of the Chief Executive Officer's performance. The Board of Directors will also review and adopt an annual strategic plan. Key objectives, as well as quantifiable operational and financial targets, and systems for the identification, monitoring and mitigation of principal business risks are incorporated into the annual strategy review. The Board of Directors ensures that a process is established that adequately provides for succession planning, including the appointing, training and monitoring of senior management.

BOARD COMPOSITION

The Board currently comprises six directors, five of whom are independent. Patricia Newson, President and Chief Executive Officer of Utility Group, is the only member of the Board of Directors who is also a member of management.

- Regular *in camera* meetings with internal and external auditors
- Three standing committees
- Five of six directors are independent

Board Committees

The Board has three standing committees: Audit and Governance; Environment, Occupational Health and Safety; and Human Resources and Compensation. The Audit and Governance, and Human Resources and Compensation committees are composed only of non-management, independent directors. The Environment, Occupational Health and Safety Committee includes a majority of non-management, independent directors. The President and Chief Executive Officer of Utility Group serves on the Environment, Occupational Health and Safety Committee. Each of the committees has a Board of Directors-approved mandate that prescribes its composition and responsibilities, as well as administrative duties.

Audit and Governance Committee

The Audit and Governance Committee comprises three independent and financially literate directors who oversee Utility Group's financial reporting and governance processes on behalf of the Board of Directors. The Audit and Governance Committee reviews, reports and provides recommendations to the Board of Directors on the annual and interim financial statements, including:

- The completeness and accuracy of Utility Group's financial reporting;
- The adequacy of risk management processes;
- The adequacy of its internal control system for financial reporting and disclosure; and
- The appointment, terms of engagement, provision of non-audit services and proposed fees of the independent auditor.

The Audit and Governance Committee meets regularly *in camera* with the external and internal auditors.

The Audit and Governance Committee:

- Is responsible for identifying individuals qualified to become Board of Director members;
- Recommends to the Board of Directors proposed nominees for election to the Board of Directors;
- Recommends Directors' compensation;
- Is responsible for reviewing, reporting and providing recommendations for improvement to the Board with respect to all aspects of governance;
- Is responsible for the orientation and education of new members of the Board of Directors and continuing development of existing members of the Board of Directors; and
- On a periodic basis, assesses the effectiveness of the Board of Directors as a whole, the Committees of the Board of Directors and the contributions of individual members.

Environment, Occupational Health and Safety

The Environment, Occupational Health and Safety Committee is responsible for reviewing, reporting and making recommendations to the Board of Directors on Utility Group's policies and procedures with respect to environment and occupational health and safety.

Human Resources and Compensation Committee

The Human Resources and Compensation Committee reviews, reports and provides recommendations to the Board of Directors regarding: the compensation of the President and Chief Executive Officer; the appointment and compensation of senior corporate officers; the compensation policy for all other employees; succession plans; and the approval of all grants of stock options.

AltaGas Utility Group Inc.
Management's Discussion and Analysis

For the year ended December 31, 2006

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The following Management's Discussion and Analysis (MD&A) of financial condition and results of operations dated February 26, 2007 is a review of the results of operations and the liquidity and capital resources of AltaGas Utility Group Inc. (Utility Group) for the year ended December 31, 2006 compared to the period ended December 31, 2005. Operations of the Utility Group began on November 17, 2005, upon acquisition of the operating businesses of Utility Group. The MD&A should be read in conjunction with the accompanying audited consolidated financial statements and notes thereto of Utility Group for the period ended December 31, 2006.

This MD&A contains forward-looking statements. When used in this MD&A the words "may", "would", "could", "will", "intend", "plan", "anticipate", "believe", "seek", "propose", "estimate", "expect", and similar expressions, as they relate to Utility Group or an affiliate of Utility Group, are intended to identify forward-looking statements. In particular, this MD&A contains forward-looking statements with respect to, among other things, business objectives, expected growth, results of operations, performance, business projects and opportunities and financial results. These statements involve known and unknown risks, uncertainties and other factors that may cause actual results or events to differ materially from those anticipated in such forward-looking statements. Such statements reflect Utility Group's current views with respect to future events based on certain material factors and assumptions and are subject to certain risks and uncertainties. Many factors could cause Utility Group's actual results, performance or achievements to vary from those described in this MD&A including, without limitation, changes in market, competition, governmental or regulatory developments, general economic conditions and other factors set out in Utility Group's public disclosure documents. These factors should not be construed as exhaustive. Should one or more of these risks or uncertainties materialize, or should assumptions underlying forward-looking statements prove incorrect, actual results may vary materially from those described in this MD&A as intended, planned, anticipated, believed, sought, proposed, estimated or expected, and accordingly such forward-looking statements included in, or incorporated by reference in this MD&A should not be unduly relied upon. Such statements speak only as of the date of this MD&A. Utility Group does not intend, and does not assume any obligation, to update these forward-looking statements except as required by law. The forward-looking statements contained in this MD&A are expressly qualified as cautionary statements.

Additional information regarding Utility Group can be found on its website at www.altagasutilitygroup.com. The continuous disclosure materials of Utility Group, including its prospectus, MD&A and audited financial statements, Annual Information Form, Information Circular and Proxy Statement, material change reports and press releases issued by Utility Group will be available through Utility Group's website or directly through the SEDAR system at www.sedar.com.

I. ALTAGAS UTILITY GROUP INC.

Utility Group was incorporated under the Canada Business Corporations Act as 6414958 Canada Limited on July 6, 2005 and changed its name to AltaGas Utility Group Inc. on July 28, 2005.

Through a series of transactions which closed on November 17, 2005, Utility Group listed on the TSX and acquired all of the outstanding shares of AltaGas Utility Holdings Inc. (AUHI). AUHI owns 100 percent of AltaGas Utilities Inc. (AUI), an indirect 24.9 percent share in Heritage Gas Limited (Heritage Gas) and a one-third share in Inuvik Gas Ltd. (Inuvik Gas).

Utility Group's financial information and the related discussion of financial results in the MD&A for the comparative period ended December 31, 2005 do not represent a complete year of operations, but rather the results of operations since Utility Group's acquisition of AUHI. The businesses owned by AUHI have operated for several years. Management has provided selected historical, comparative information for the business of AUHI in this MD&A for the years ending December 31, 2005 and 2004.

II. OVERVIEW OF THE BUSINESS AND STRATEGY

The business of Utility Group is the ownership and operation of regulated natural gas transmission and distribution facilities in Alberta, Nova Scotia and the Northwest Territories, Canada that deliver or sell natural gas to end-users. Utility Group's operating companies are not involved in the exploration for, or production or long-distance transmission of, natural gas. These natural gas distribution utilities' earnings are highly seasonal, as revenues are primarily based on the demand for space heating in the winter

months, mainly from November to March. Costs, on the other hand, are generally incurred more uniformly over the year. This typically results in profitable first and fourth quarters and net losses in the second and third quarters. Earnings can be impacted by variations from normal weather resulting in delivered volumes being different than anticipated. Changes in the number of customers or in customer usage are examples of factors that might typically offset the impacts of weather variations.

AUI and Heritage Gas operate in regulated marketplaces where, as franchise holders, they are allowed the opportunity to earn regulated rates of return that provide for recovery of costs and a return on capital from the franchise capital investment base. Return on rate base comprises regulatory allowed financing costs and return on common equity. Inuvik Gas operates a natural gas distribution franchise in a "light-handed" regulatory environment where delivery service and natural gas pricing are market based.

Utility Group's strategy is to grow existing business through infill and expansion of services within current franchise areas or, in the case of Heritage Gas to develop new systems in new market areas. In addition, Utility Group actively pursues the prudent acquisition of other utility infrastructure businesses in Canada. Utility Group's management team and Board of Directors have significant utility management, acquisition and capital markets experience. Management of Utility Group believes this experience will ensure prudent management and financing of existing capital commitments to support the expansion of AUI's systems, the build-out of the Heritage Gas system and new growth opportunities as they are identified.

III. ALTAGAS UTILITY GROUP INC. FINANCIAL AND OPERATING RESULTS

Utility Group's financial information and the related discussion of financial results in the MD&A for the year ended December 31, 2006 and the period ended December 31, 2005 reflect its financial results since incorporation on July 6, 2005 and the consolidation of the operating results of AUHI from November 17, 2005 forward.

Consolidated Financial Results

($ millions, except per share amounts or otherwise noted)	**2006**	2005[1]
Revenue	**130.9**	30.5
Net revenue[2]	**35.7**	5.6
EBITDA[2]	**15.5**	2.9
Operating income[2]	**8.8**	2.0
Net income	**4.2**	1.3
Funds generated from operations[2]	**10.6**	2.0
Total assets	**184.0**	175.5
Long-term liabilities	**86.2**	79.3
Shares outstanding *(thousands)*		
Basic	**8,190**	8,190
Diluted	**8,202**	8,200
Net income per share – basic[3]	**$ 0.52**	$ 0.15
Net income per share – diluted[3]	**$ 0.51**	$ 0.15

(1) The period ended December 31, 2005 includes operations since the acquisition of AUHI on November 17, 2005.

(2) Non-Generally Accepted Accounting Principles (GAAP) financial measure: see discussion in "Non-GAAP Financial Measures" section of this MD&A.

(3) Net income per share was calculated using the average number of shares outstanding from the period November 17 to December 31, 2005 of 8,189,905 as there was no operating income prior to November 17, 2005.

1. Discussion of Consolidated Financial Results for the Year Ended December 31, 2006

Net income for the year ended December 31, 2006 was $4.2 million or $0.52 per share, comprising operating income of $8.8 million, partially offset by $3.6 million of interest expense and $1.0 million of income taxes. Net income for the six-week period ended December 31, 2005 was $1.3 million, or $0.15 per share, comprising operating income of $2.0 million, partially offset by $0.4 million of interest expense and $0.3 million of income taxes.

While the 2006 net income was slightly higher than anticipated for this first full year of operations, there were a number of unanticipated offsetting items impacting results over the year. Compared to management's expectations, 2006 net income was:

Net Income Variances from Anticipated

($ millions)		**2006**
Lower due to:		
Regulatory decisions allowing:		
Lower than requested recoveries of operating expense at AUI	(0.9)	
Lower than requested interest expense on $30.0 million five-year AUI debenture	(0.4)	
Benefit from change in method of billing for fixed change component of AUI's delivery rates	0.4	**(0.9)**
Volumetric variances:		
Warmer than normal weather	(0.4)	
Higher deliveries due to customer growth at AUI and Heritage Gas	0.1	**(0.3)**
Higher due to:		
Expenses lower than anticipated:		
Operating and administrative	0.2	
Operating and administrative higher capitalization	0.2	
Depreciation and amortization	0.2	
Income tax expense	0.9	**1.5**

Utility Group's revenue for the year ended December 31, 2006 was $130.9 million. Revenues from AUI comprise 96.6 percent of consolidated revenue and were $80.9 million lower than anticipated. Of the shortfall from expected, $61.9 million was due to lower cost of gas recoverable, $6.1 million to warmer than normal weather, $9.1 million due to a shift of customers to retail supply, which excludes the cost of natural gas revenue flow through, and $3.4 million from a reduction in demand based customer revenue.

For the year ended December 31, 2006 Utility Group reported net revenue of $35.7 million ($5.6 million – 2005), after natural gas costs of $95.2 million ($24.9 million – 2005). Net revenue was $2.1 million lower than anticipated due to regulatory decisions and $0.7 million due to warmer than normal weather, partially offset by $0.6 million due to the change in the method of billing the fixed charge component of AUI's delivery rates in the first quarter of 2006.

Operating and administrative expenses of $20.2 million for 2006 ($2.7 million – 2005) were $0.6 million lower than anticipated as some operating expenses and the full staff complement were not reached until late in 2006 and because of increased capitalization of overhead due to high construction activity.

Depreciation and amortization expense was $6.7 million in 2006 ($0.9 million – 2005), all of which was related to the property, plant and equipment of the operating entities. This expense was lower than anticipated in 2006 due to lower regulator-approved depreciation rates at AUI, partially offset by increased depreciation at Heritage Gas due to a higher investment in property, plant and equipment.

Interest expense for the year ended December 31, 2006 was $3.6 million, approximately as anticipated for the year. Average debt outstanding on the short and long-term credit facilities for the year was $72.6 million and the average interest rate was 4.6 percent.

Utility Group's income tax expense for the year ended December 31, 2006 was $1.0 million ($0.3 million – 2005). Current income tax expense was incurred primarily by AUI, which under utility board regulation accounts for income tax expense using the taxes payable method and therefore reports only income tax due on current taxable earnings. Income tax expense for 2006 was lower than anticipated as a result of higher expenses for tax purposes than for accounting purposes.

2. Business Operations

Operating Information

	2006	2005[5]
Deliveries (PJ)[1][2]		
End-use	**13.9**	13.8
Transportation	**10.5**	10.4
	24.4	24.2
Service sites at period end[3]	**65,066**	62,854
Degree day variance (percent)[4]	**(5.3)**	(5.0)

(1) A petajoule (PJ) is 1 million gigajoules.

(2) Deliveries reflect Utility Group's 100 percent share in AUI and its proportionate share of Heritage Gas (24.9 percent) and Inuvik Gas (one-third).

(3) Service sites reflect all of the service sites of AUI, Heritage Gas and Inuvik Gas.

(4) Degree days relate to AUI's service area. A degree day is the cumulative extent to which the daily mean temperature falls below 18 degrees Celsius. Normal degree days are based on a 20-year rolling average. Positive variances from normal lead to increased delivery volumes from normal expectations. See "Sensitivity Analysis" for a discussion of the impact of degree days on Utility Group's net income.

(5) 2005 PJs delivered were for AUHI's 12 months of operations.

Natural Gas Deliveries

	2006		2005	
	Service Sites[3]	**PJs[1][2]**	Service Sites[3]	PJs[1][2][5]
Type of Service				
Regulated retail sites	**64,345**	**11.7**	62,284	11.5
Core market services	**670**	**0.9**	517	0.6
End-use transportation service sites	**51**	**2.7**	53	1.7
Producer transporters[2]		**9.1**		10.4
	65,066	**24.4**	62,854	24.2
Operating Business				
AUI	**63,532**	**24.2**	61,730	24.1
Heritage Gas	**733**	**0.1**	369	–
Inuvik Gas	**801**	**0.1**	755	0.1
	65,066	**24.4**	62,854	24.2
Type of Customer				
Residential	**57,921**	**7.5**	56,108	7.1
Commercial	**6,390**	**4.1**	6,153	4.4
Industrial	**34**	**0.1**	23	–
End-use transportation, core market services producer transporters	**721**	**12.7**	570	12.7
	65,066	**24.4**	62,854	24.2

(1) A petajoule (PJ) is 1 million gigajoules.

(2) Deliveries reflect Utility Group's 100 percent share in AUI and its proportionate share of Heritage Gas (24.9 percent) and Inuvik Gas (one-third).

(3) Service sites reflect all of the service sites of AUI, Heritage Gas and Inuvik Gas.

(4) Revenues derived from the three producer transporters are generated from capacity charges and do not vary significantly with changes in energy transported. While producer transportation comprises a significant percentage of total throughput, this service generates considerably less revenue than that generated from delivery services.

(5) 2005 PJs delivered were for AUHI's 12 months of operations.

AltaGas Utilities Inc.

In Alberta, natural gas distribution consumers have the option of buying natural gas from retail gas suppliers at a contracted rate or from their delivery utility at the regulated rate determined for the utility. Most consumers in AUI's service areas take natural gas at the regulated rate provided by AUI. As of December 31, 2006, 670 of AUI's 63,532 service sites purchased their natural gas from a retail gas supplier, taking core market service (delivery only) from AUI. To AUI's knowledge, no residential customers of AUI have elected to receive gas supply from retail gas suppliers. Consumers electing to purchase gas supply from retail gas suppliers are typically associated with organizations such as the Alberta Urban Municipalities Association, retail store chains, or other business associations.

The growth in AUI's service sites and of its business is driven by economic growth in established franchises creating infill and expansion opportunities, moderately enhanced by occasional franchise acquisitions. This growth in services within the AUI franchise areas has averaged approximately 2 percent per year over the three years prior to 2006, with an increase to 3 percent growth in 2006. Management expects the infill growth rate to continue at 2 to 3 percent per year.

Infill demand growth for space and water heating fuel within AUI's franchise service areas is concentrated in town distribution systems and relates to servicing new homes and commercial developments with natural gas. AUI has historically captured, and expects to continue to capture, almost 100 percent of this growth. Overall, AUI serves almost all of the potential market in its existing service areas.

AUI's market consists primarily of residential and small commercial consumers located in smaller population centres or rural areas of Alberta. In 2006, AUI added 1,963 new service sites to its 2005 year end active service sites, an increase of 40 percent over the 1,403 additions in 2005. Approximately 90 percent of AUI's total 2006 new customer connections were for residential service. The remaining 10 percent of new service connections were primarily for varying levels of commercial service. The split between residential and commercial service followed the historical overall trend.

In 2006, 61 percent of AUI's new services and 70 percent of the 79 subdivision proposals accepted by developers were in areas surrounding Edmonton. This area is experiencing strong economic growth due to the surging Alberta economy, particularly with respect to heavy oil and oil sands development in the northeast sector of the province. The Leduc operating district situated near the Edmonton International Airport experienced 6.2 percent growth in service site additions in 2006 (3.9 percent – 2005). Growth in this district represented 51 percent of AUI's 2006 service site growth.

As is typical, given the urgency created by the colder weather and the demand for heat as new buildings are being constructed, construction activity accelerated in the last quarter of 2006. Approximately 38 percent of total new services were installed and 50 percent of total subdivision work was completed in the fourth quarter of 2006.

While AUI aggressively pursues opportunities to develop service areas that are not currently served with natural gas, in recent years expansion opportunities have typically been the extension of gas service to very small communities in northern Alberta. AUI has had success in these areas due to its responsive and cost-efficient approach to delivering natural gas service. Such expansion opportunities in Alberta represent relatively minor asset growth, but AUI remains committed to pursuing expansion projects that meet management's target return on investment.

Historically, opportunities to acquire investor-owned, municipally owned or member-owned gas utilities have arisen and AUI has been successful in capitalizing on these opportunities. In 2005 AUI acquired the distribution assets of the last small, investor-owned natural gas distributor in Alberta. Future opportunities for growth through acquisition within Alberta are therefore expected to be limited and are likely to be distribution systems serving less than 1,000 service sites. While there is no way of predicting if or when distribution system acquisition opportunities will arise, AUI will pursue opportunities that meet its corporate investment criteria.

Heritage Gas Limited

At the end of 2006 there were approximately 1,700 commercial energy consumers (1,000 – 2005), and approximately 2,700 residential energy consumers (1,500 – 2005) with access to the Heritage Gas distribution system in the Halifax Regional Municipality and in the Town of Amherst and Cumberland County. Potential customers have the opportunity to switch heating fuel sources, mainly from oil or electricity, to natural gas. At December 31, 2006 Heritage Gas' distribution system comprised 137.5 kilometres of pipeline infrastructure including the 51.5 kilometres of pipeline added in 2006. At the end of 2006 Heritage Gas had installed service lines to 928 customers, of which 733 were activated by year-end, an increase of 110 percent over 2005. Natural gas delivered in 2006 totalled 470,634 GJ, an increase of 335 percent over 2005.

Major projects in 2006:

- Upgraded Thornhill Town border regulating station to a capacity of 50,000 GJ per day from 18,000 GJ per day to serve the Woodside and Burnside industrial parks;
- Constructed gas mains to the Halifax International Airport area, with the first of several committed customers receiving natural gas service;
- Constructed service line to the Dartmouth General Hospital; projected in-service date second quarter 2007;
- Expanded Dartmouth system to Woodside and Russell Lake;
- Expanded in the Burnside Industrial Park and Dartmouth Crossing; and
- Expanded Amherst distribution system by 12 kilometres, a 34 percent increase over 2005.

Major projects in 2005:

- Constructed Town of Amherst and Cumberland County systems;
- Expanded in the Burnside Industrial Park;
- Expanded Dartmouth residential services; and
- Constructed approximately 15 kilometres of lines in Dartmouth, bringing total to 52 kilometres.

Due to its short time in the marketplace, Heritage Gas currently has a very small share of the Nova Scotia energy end-use market. To increase its market penetration, Heritage Gas is planning numerous development projects for the Greater Dartmouth and Amherst areas, including continued expansion in Burnside Industrial Park, and to cross the Halifax Harbour to serve the Halifax Peninsula. Heritage Gas' medium-term expansion plans are for growth opportunities that are contiguous to its current operations.

Inuvik Gas Ltd.

In Inuvik, several of the government buildings (including public housing, schools, the hospital and the college) were converted to natural gas service during the initial start-up of the distribution system in the fall of 1999. Other commercial and residential buildings have subsequently been converted, bringing the total number of buildings using natural gas service at December 31, 2006 to 801, up from 755 at December 31, 2005. The average volume of natural gas distributed in 2006 was 842 GJ/day, versus 851 GJ/day in 2005. Ambient temperature in 2006 was 3 percent warmer than in 2005, resulting in lower volumes of gas delivered in 2006 than in 2005.

3. Regulatory Metrics

AUI and Heritage Gas are subject to traditional utility regulation by the Alberta Energy and Utilities Board (EUB) and Nova Scotia Utility and Review Board (NSUARB) respectively. AUI and Heritage Gas are allowed the opportunity to earn returns set by the regulators on the approved rate bases as approved by the regulators. Rate bases, deemed capital structures and returns are set out in the table below.

Inuvik Gas is regulated by the Northwest Territories Public Utilities Board (NWTPUB) and is presently exempt from full regulation as a public utility. The NWTPUB is satisfied that competition for alternative fuels in Inuvik is sufficient to negate the need for full regulation. As a result, Inuvik Gas is subject to regulation on a complaints basis and is required to file its rates and terms and conditions of service with the NWTPUB when they are revised. The NWTPUB may review Inuvik Gas' business operations, earnings and accounts as it deems necessary.

Regulatory Metrics

($ millions, except as otherwise noted)	**2006**	2005
Rate Base (net of contributions in aid of construction)		
AUI[1]	**97.4**	92.4
Heritage Gas[2][3]	**8.4**	4.6
Inuvik Gas[3][4]	**1.4**	1.5
	107.2	98.5
Deemed Capital Structure (debt %/equity %)		
AUI	**59/41**	59/41
Heritage Gas	**55/45**	55/45
Inuvik Gas	**n/a**	n/a
Return on Debt (%)		
AUI	**5.72**	6.22
Heritage Gas	**8.75**	8.75
Inuvik Gas	**n/a**	n/a
Return on Equity (%)		
AUI[5]	**8.93**	9.50
Heritage Gas[6]	**13.00**	13.00
Inuvik Gas	**n/a**	n/a

(1) Mid-year rate base.

(2) Heritage Gas earns a return on its weighted average rate base over the year.

(3) Reflects Utility Group's proportionate share.

(4) As the NWTPUB does not apply traditional regulation to Inuvik Gas, the figure shown is the net investment in property, plant and equipment.

(5) EUB has set return on equity for 2007 at 8.51 percent.

(6) Heritage Gas' return on equity for 2007 through 2011 is 13.0 percent.

AUI's 5.4 percent increase in rate base to $97.4 million was driven by capital expenditures required to service new sites and to replace and improve existing facilities, offset in part by amortization of existing plant and facilities. AUI is seeking approval in its 2007 General Rate Application (GRA) for a 7.6 percent increase from its 2006 approved rate base to $104.6 million.

Heritage Gas' year end rate base was $51.1 million (Utility Group's share – $12.7 million) at the end of 2006 compared to $28.3 million (Utility Group's share – $7.0 million) at the end of 2005. The increase in rate base was due to growth in the distribution system to provide natural gas distribution service to new customers. Heritage Gas expects that if the Halifax Harbour crossing occurs in 2007, year end rate base will reach $79.1 million by the end of 2007. While year end rate base is indicative of the pace of growth at Heritage Gas, regulatory returns are earned on weighted average rate base over the year. Heritage Gas' weighted average rate base was $33.9 million for 2006 (2005 – $18.5 million) of which $8.4 million was Utility Group's proportionate share (2005 – $4.6 million).

4. Regulatory Process

AltaGas Utilities Inc.

On November 29, 2005 the EUB released Decision 2005-127 in which it set the Phase 1 revenue requirements for AUI for the test years 2005 and 2006, using a placeholder for the cost of new debt. That placeholder was to be used until the EUB rendered its decision on AUI's October 28, 2005 application for approval to issue a $30.0 million, five-year debenture to AUHI with an all-in interest rate of 7.05 percent. The debenture replaced a $30.0 million, five-year debenture to AUHI that bore interest at 7.42 percent and matured on October 4, 2005. On May 24, 2006 the EUB issued Decision 2006-049, allowing AUI to issue the $30.0 million debenture to AUHI, but disallowing the all-in rate of 7.05 percent, instead approving an interest rate of 5.44 percent. An adjustment of $0.2 million was recorded in 2006 to reverse the disallowed interest recovery booked in 2005. The annual impact of the 161 basis point disallowance is a reduction in anticipated revenue by $0.5 million per year and anticipated net income by $0.3 million. On October 31, 2006 AUI filed a Review and Variance Application to request that the EUB reconsider its decision with respect to the $30.0 million debenture. The EUB is still considering its position on undertaking a review. Any impact of a Review and Variance will be reflected in a future period when its outcome is known.

Decision 2005-127 and Decision 2006-049 set the Phase I revenue requirements for the 2005 and 2006 test years. Approved revenue requirements, net of gas-related costs for the test years, were $32.0 million for 2005 and $33.1 million for 2006. These represented increases in revenue requirement of $2.3 million (7.7 percent) and $3.4 million (11.4 percent) from the 2004 approved revenue requirement of $29.7 million.

AUI filed an application for Phase 2 of its 2005/2006 GTA in December 2006. This application updated the delivery tariffs and addressed the directives issued by the EUB in Decision 2005-029 (the 2003/2004 Phase 2 GTA). These directives related to unbundling (or separating out) within rates certain customer care costs and modifying some allocations within the cost of service study. These directives will have no impact on total cost of service or on the Utility Group's financial results. A Phase 2 hearing is scheduled for June 2007, with a decision expected in the fourth quarter of 2007.

On December 29, 2006 AUI filed Phase 1 of its 2007 GRA. AUI is seeking approval of a forecast rate base of $104.6 million, an increase of $7.4 million from its 2006 approved rate base of $97.2 million. AUI is also seeking approval of a revenue requirement, net of gas costs, of $37.5 million, which is an increase of $4.4 million (13.3 percent) from the 2006 allowed net revenue requirement of $33.1 million. A hearing is expected in mid-2007 and a decision from the EUB is expected in the fourth quarter of 2007.

Heritage Gas Limited

On September 1, 2006 Heritage Gas filed a General Tariff Application (GTA) for the five-year test period starting January 1, 2007. The NSUARB decision was received December 21, 2006 and approved the five-year test period starting January 1, 2007. Highlights of the approved GTA are as follows:

- Tariffs and rates approved for the five-year test period;
- Annual rate increase of 2.5 percent effective January 1, 2007 through January 1, 2011;
- Capital structure of 55 percent debt and 45 percent equity;
- 8.75 percent cost of debt;
- Rate of return on equity of 13.0 percent; and
- Extended the use of the Revenue Deficiency Account (RDA).

The RDA is based on the difference between Heritage Gas' actual revenue billed and the revenue required to earn the rates of return approved by the NSUARB. In Heritage Gas' current customer development stage, it is expected that the actual revenue billed will be less than the revenue required to earn the approved rates of return and therefore the RDA asset will accumulate. As the distribution network matures, the actual revenue billed is expected to exceed the revenue required to earn the approved rates of return and the RDA will be drawn down. The economic model filed for January 2007 to comply with the directives of the decision projects to recover the RDA by 2019, but the NSUARB has granted permission to use the RDA until such time as it is drawn down to zero. Utility Group's proportionate share in the RDA balance at December 31, 2006 was $2.6 million ($1.3 million – 2005).

The next rate application is anticipated in 2011 for test years commencing 2012.

Inuvik Gas Ltd.

On August 21, 2006 Inuvik Gas notified the NWTPUB of a natural gas rate increase effective October 22, 2006. In October 2006, the Town of Inuvik filed a complaint regarding the applied-for price increases. Inuvik Gas, the Town of Inuvik and the NWTPUB met on February 15, 2007 to discuss the rate increase. A decision was not reached at the meeting and Inuvik Gas and The Town of Inuvik have agreed to continue meeting.

5. Non-GAAP Financial Measures

Utility Group provides financial measures in this MD&A that do not have a standardized meaning prescribed by Canadian generally accepted accounting principles (GAAP). These non-GAAP financial measures may not be comparable to similar measures presented by other corporations. The purpose of these financial measures and their reconciliation to GAAP financial measures is discussed below.

Non-GAAP information is also provided for AUHI for 2004 and 2005. The reader is cautioned that the AUHI results are provided as information only and may include transactions that may no longer be pertinent as a result of its ownership by Utility Group, and do not include transactions incurred by Utility Group directly.

Net Revenue

($ millions)	Utility Group[1] 2006	July 6 – December 31, 2005	AUHI 2005[2] (unaudited)	2004[3]
Net revenue	**35.7**	5.6	34.3	30.7
Add: Cost of natural gas	**95.2**	24.9	109.6	94.0
Revenue (GAAP financial measure)	**130.9**	30.5	143.9	124.7

(1) Financial information for the year ended December 31, 2006 and for the period ended December 31, 2005 from the audited consolidated financial statements of Utility Group. From November 17, 2005 the results of AUHI are consolidated in the audited financial statements of Utility Group.

(2) The selected AUHI financial information for the year ended December 31, 2005 is unaudited. An audit of AUHI was not required for the year ended December 31, 2005. From November 17, 2005 the results of AUHI are consolidated in the audited financial statements of the Utility Group.

(3) The selected AUHI financial information for the year ended December 31, 2004 was extracted from audited consolidated financial statements of AUHI included in the Prospectus filed by Utility Group on November 4, 2005.

Management believes that net revenue better reflects operating performance than does revenue as changes in the market price of natural gas purchased for resale affect both revenue and the cost of natural gas.

Operating Income

($ millions)	Utility Group[1] 2006	July 6 – December 31, 2005	AUHI 2005[2] (unaudited)	2004[3]
Operating income	**8.8**	2.0	8.6	7.7
Deduct: Interest expense	**3.6**	0.4		
Income taxes[4]	**1.0**	0.3		
Net income (GAAP financial measure)	**4.2**	1.3		

(1) Financial information for the year ended December 31, 2006 and for the period ended December 31, 2005 from the audited consolidated financial statements of Utility Group.

(2) The selected AUHI financial information for the year ended December 31, 2005 is unaudited. An audit of AUHI was not required for the year ended December 31, 2005. From November 17, 2005 the results of AUHI are consolidated in the audited financial statements of Utility Group.

(3) The selected AUHI financial information for the year ended December 31, 2004 was extracted from audited consolidated financial statements of AUHI included in the Prospectus filed by Utility Group on November 4, 2005.

(4) Income taxes consist of current and future income taxes.

Operating income is used by management to measure operating performance without reference to financing decisions and income tax impacts, which are not controlled by the operating businesses.

EBITDA

	Utility Group (1)		AUHI	
($ millions)	2006	July 6 – December 31, 2005	2005 (2) (unaudited)	2004 (3)
EBITDA	**15.5**	2.9	16.1	14.3
Deduct: Depreciation and amortization	**6.7**	0.9		
Interest expense	**3.6**	0.4		
Income taxes (4)	**1.0**	0.3		
Net income (GAAP financial measure)	**4.2**	1.3		

(1) Financial information for the year ended December 31, 2006 and for the period ended December 31, 2005 from the audited consolidated financial statements of Utility Group. From November 17, 2005 the results of AUHI are consolidated in the audited financial statements of Utility Group.

(2) The selected AUHI financial information for the year ended December 31, 2005 is unaudited, as an audit of AUHI was not required for the year ended December 31, 2005.

(3) The selected AUHI financial information for the year ended December 31, 2004 was extracted from audited consolidated financial statements of AUHI included in the Prospectus filed by Utility Group on November 4, 2005.

(4) Income taxes include both current and future income taxes.

Earnings before interest, taxes, depreciation and amortization (EBITDA) are used by management to understand the ability of the business to generate cash and to cover interest payments, fund capital expenditures and pay cash income taxes.

Funds Generated from Operations

	Utility Group (1)	
($ millions)	2006	July 6 – December 31, 2005
Funds generated from operations	**10.6**	2.0
Net change in non-cash working capital	**(1.9)**	(4.7)
Cash from operations (GAAP financial measure)	**8.7**	(2.7)

(1) Financial information for the year ended December 31, 2006 and for the period ended December 31, 2005 was extracted from the audited consolidated financial statements of Utility Group.

Funds generated from operations are provided to assist in determining Utility Group's ability to generate cash from operations, after interest and taxes, without regard to changes in non-cash working capital in the period.

IV. ALTAGAS UTILITY HOLDINGS INC.'S RESULTS OF OPERATIONS

The businesses acquired on the acquisition of AUHI by Utility Group on November 17, 2005 have operated for many years. Selected financial information is provided for AUHI which owns 100 percent of AUI, an indirect 24.9 percent share in Heritage Gas and a one-third share in Inuvik Gas. Management believes that information regarding the results of AUHI's operations for the years 2004, 2005 and 2006 will be useful to the reader to assess the operations of Utility Group. The reader is cautioned that the AUHI results are provided as information only and may include transactions that may no longer be pertinent as a result of its ownership by Utility Group, and do not include transactions incurred by Utility Group directly.

Selected Financial and Operating Information of AltaGas Utility Holdings Inc.

($ million, except as otherwise noted)	**2006**[1] (unaudited)	2005[1] (unaudited)	2004[3]
Revenue	**130.9**	143.9	124.7
Net revenue[4]	**35.7**	34.3	30.7
EBITDA[4]	**16.4**	16.1	14.3
Operating income[5]	**9.7**	8.6	7.7
Deliveries (PJ)[5]			
End-use	**13.9**	13.8	16.0
Transportation	**10.5**	10.4	10.3
	24.4	24.2	26.3
Service sites at period end[2]	**65,066**	62,854	61,294
Degree day variance (percent)[6]	**(5.3)**	(5.0)	2.6

(1) Financial results and deliveries reflect AUHI's 100 percent interest in AUI and its proportionate share of Heritage Gas (24.9 percent) and Inuvik Gas (one-third), and are unaudited except for 2004.

(2) Service sites reflect all of the service sites of AUI, Heritage Gas and Inuvik Gas.

(3) The financial information, except for non-GAAP measures, for the year ended December 31, 2004 was extracted from the audited consolidated financial statements of AUHI, included in the Prospectus filed by Utility Group on November 4, 2005.

(4) Non-GAAP financial measure: see discussion in "Non-GAAP Financial Measures" section of this MD&A.

(5) A petajoule (PJ) is 1 million gigajoules.

(6) Degree days relate to AUI's service area. A degree day is the cumulative extent to which the daily mean temperature falls below 18 degrees Celsius. Normal degree days are based on a 20-year rolling average. Positive variances from normal lead to increased delivery volumes from normal expectations. See "Sensitivity Analysis" for a discussion of the impact of degree days on Utility Group's net income.

1. Year Ended December 31, 2006 Compared to December 31, 2005 (Unaudited)

Revenue for the year ended 2006 was $130.9 million, a decrease of $13.0 million from 2005. Fluctuations in revenue were mainly due to the cost of natural gas, which flows through to customers, and the volumes delivered. $14.7 million of the decrease in revenue for 2006 was attributable to AUI. AUI's revenue variance to 2005 included $15.5 million due to lower natural gas costs offset by $1.2 million due to higher retail sales, which exclude revenues associated with the cost of gas pass-through compared to default supply sales, partially offset by a $2.0 million increase due to growth. The cost of natural gas and growth in the business at Heritage Gas contributed $0.9 million to offset the revenue decrease from AUI.

Net revenue for the year ended December 31, 2006 was $35.7 million, an increase of $1.4 million from 2005. AUI contributed $0.5 million of the increase, Heritage Gas contributed $0.7 million, and Inuvik Gas contributed $0.2 million. Net revenue is unaffected by changes in natural gas prices as the cost of natural gas is recovered from customers.

Operating and administrative expenses for the year ended December 31, 2006 were $19.2 million, an increase of $1.0 million from 2005. The increase was due to staff and wage rate increases, and higher pension costs as a result of a reduction in the discount rate.

EBITDA for the year ended December 31, 2006 was $16.4 million, an increase of $0.3 million from 2005. Higher net revenue was partially offset by increases in operating expenses.

AUI's capital expenditures, net of contributions in aid of construction were $10.8 million and $9.5 million in 2006 and 2005, respectively. In 2006 $3.9 million of these expenditures related to new business (2005 – $2.6 million), $3.7 million related to system betterment (2005 – $3.9 million) and $3.2 million related to general plant additions and replacements (2005 – $3.0 million).

AUHI's share of capital expenditures for delivery system expansion at Heritage Gas was $4.8 million in 2006 compared to $4.3 million in 2005.

V. UTILITY GROUP'S FINANCIAL POSITION

The purchase of AUHI by Utility Group resulted in a substantive change in ownership of AUHI and is accounted for as a business combination at fair market value. Purchase consideration for the acquisition was allocated to the underlying tangible and intangible assets based on management's estimates of their fair value. In management's assessment, the assumptions used to determine the allocation are reasonable.

The following table outlines the significant changes in the consolidated balance sheets of Utility Group from December 31, 2005 to December 31, 2006.

Balance Sheet Item *($ millions)*	Increase (decrease)	Explanation
Accounts receivable	(3.6)	Lower gas costs and the collection of 2005 regulatory revenue requirements at AUI.
Property, plant and equipment (net of accumulated depreciation)	10.7	Network expansion $11.9, system betterment of $3.9 and $3.3 to general plant additions and replacements (AUI $11.7, Heritage Gas $4.8), net of CIAC of $3.5.
Regulatory assets	1.9	Increases in deferred charges of $0.7 and an increase in the revenue deficiency account of $1.2.
Accounts payable	(4.3)	Reduction in trade payables, reflecting the reduced price of gas.
Short-term debt	2.2	Borrowings on credit facilities to fund capital expansion in excess of cash from operations.
Long-term debt	6.0	Borrowings from credit facilities to fund capital expansion.
Customer deposits and other long-term liabilities	0.9	Increase in customer deposits.

VI. FINANCIAL INSTRUMENTS

Financial instruments which subject Utility Group to credit risk consist primarily of accounts receivable. Accounts receivable credit risk is reduced due to a large and diversified customer base, customer deposits for at-risk customers and the ability to recover the majority of uncollectible accounts through regulator-approved customer rates.

Utility Group draws on its revolving term credit facility to fund its operations with floating rate debt, which exposes Utility Group to changes in interest payments due to fluctuations in interest rates.

VII. INVESTED CAPITAL

During 2006, Utility Group invested $20.9 million in property, plant and equipment and regulatory and other assets. The 2006 investment in property, plant and equipment included $14.6 million at AUI and $4.5 million at Heritage Gas. Of the $20.9 million, $11.9 million, or 56.9 percent was spent to expand the systems to service new sites.

Net Capital Invested

($ millions)	**2006**
Invested capital:	
Property, plant and equipment	19.1
Regulatory and other assets	1.8
	20.9
Contributions and disposals	
Contributions in aid of construction	(3.5)
Disposition of property, plant and equipment	(0.2)
	(3.7)
	17.2

Net Capital Invested

($ millions)	**2006**
Invested capital:	
New business	11.9
System betterment and gas supply	3.9
General plant	3.3
Regulatory and other assets	1.8
	20.9
Contributions and disposals	
New business	(3.5)
System betterment and gas supply	(0.2)
General plant	–
	(3.7)
	17.2

Utility Group categorizes its invested capital into new business, system betterment and gas supply, and general plant.

VIII. LIQUIDITY AND CAPITAL RESOURCES

Utility Group expects that 2007 funds from operations will be sufficient to meet the majority of its budgeted maintenance and growth capital. The balance of its budgeted growth capital and a certain value of acquisitions will be financed through existing bank lines. Should larger acquisitions require financing beyond existing lines, management believes equity and debt capital markets could be accessed to provide additional financing. At this time, Utility Group does not reasonably expect any presently known trend or uncertainty to affect Utility Group's ability to access its anticipated sources of cash.

Cash Position

($ millions)	**December 31, 2006**	December 31, 2005
Cash, beginning of year	**0.4**	–
Operating activities	**8.7**	(2.7)
Investing activities	**(17.2)**	(75.3)
Financing activities	**8.4**	78.4
Cash, end of year	**0.3**	0.4

Cash from Operations

Cash provided by operations of $8.7 million in 2006 was based on funds generated from operations of $10.6 million, reduced by $1.9 million due to the net change in non-cash working capital. Cash used in operations for the period from November 17 to December 31, 2005 was $2.7 million based on funds generated from operations of $2.0 million, reduced by the net change in non-cash working capital of $4.7 million.

Investing Activities

In 2006 cash used in investing activities was $17.2 million. Property, plant and equipment additions of $19.1 million and $1.8 million invested in regulatory and other assets were partially offset by $3.5 million in contributions in aid of construction and $0.2 million in proceeds of disposition of property, plant and equipment.

The November 17, 2005 assumption of AUHI debt for $74.7 million comprised the majority of the $75.3 million of cash flow used in investing activities net of $2.5 million in cash acquired. The balance was primarily expenditures on property, plant and equipment for the natural gas distribution systems of AUHI for the period after November 17, 2005 and reimbursement of contributions in aid of construction.

Financing Activities

In 2006 cash generated by financing activities was $8.4 million, $8.2 million of which was borrowed under bank lines and $0.9 million of which was due to increased customer deposits and other liabilities, partially offset by dividends paid of $0.7 million.

In 2005, cash generated by financing activities was $78.4 million, consisting of $75.7 million borrowed under bank lines, and $2.7 million received on the issuance of common shares.

Capital Resources

Utility Group believes that its access to debt and equity markets, unused bank credit facilities and its funds generated from operations will provide it with sufficient capital resources and liquidity to fund existing operations and certain acquisition and expansion opportunities in 2007.

The use of debt or equity funding is based on Utility Group's target capital structure, which is determined by considering the norms and risks associated with each of its businesses and capital structures deemed by the EUB and the NSUARB. Utility Group targets a debt-to-total capitalization ratio of between 50 and 60 percent. Utility Group's debt-to-total capitalization ratio as at December 31, 2006 was 56.4 percent (55.2 percent – 2005).

Utility Group funds its long and short-term borrowing requirements with credit facilities from a syndicate of Canadian chartered banks and from the Province of Nova Scotia.

Credit Facilities

($ millions)	**Drawn at December 31, 2006**	Drawn at December 31, 2005
Demand operating credit facility	**2.2**	–
Revolving, term credit facility	**81.8**	75.8
Loan from Province of Nova Scotia	**1.4**	1.4
	85.4	77.2

Effective December 31, 2006 Utility Group had banking arrangements as follows:

- An extendible revolving credit facility with a syndicate of Canadian chartered banks for $100.0 million under which prime rate loans, USBR loans, letters of credit, bankers' acceptances and LIBOR loans may be drawn, repayable on November 17, 2009. The maturity date is extendible upon consent of each lender for further successive one-year periods. At December 31, 2006, bankers' acceptances with short-term maturities of $81.8 million had been issued.
- A demand operating credit facility with a Canadian chartered bank for $10.0 million under which prime rate loans, USBR loans, letters of credit, bankers' acceptances and LIBOR loans may be obtained, repayable in full upon demand. Loans draws as of December 31, 2006 were $2.2 million (2005 – no funds drawn) against this facility.

Utility Group has not been rated by any credit agencies, nor does Utility Group expect to be rated.

All of the borrowing facilities have financial tests and other covenants customary for these types of facilities, which must be met at each quarter-end. At December 31, 2006 Utility Group was in compliance with these covenants.

Servicing and Repayment of Debt

In November 2005 Utility Group completed an equity financing, selling 390,000 shares under a public equity offering. The net proceeds of $2.7 million were used by Utility Group to repay long-term debt and for working capital. Utility Group expects to meet interest payments on outstanding indebtedness from internally generated funds, but may rely upon the proceeds of new financings to meet its principal debt obligations when due.

Utility Group Contractual Obligations

Utility Group and its operating businesses have contractual obligations in the normal course of business for the next five years and for the period thereafter.

Contractual Obligations

		Payments due by period			
($ millions)	Total	Less than 1 year	1-3 years	4-5 years	After 5 years
Long-term debt[1]	83.2	–	81.8	–	1.4
Operating leases	0.2	0.1	0.1	–	–

(1) See Notes to the consolidated financial statements.

Inuvik Gas purchases gas for resale from the Ikhil Joint Venture under a 15-year gas purchase agreement at a price adjusted annually on August 1 based on the change in the average price of high sulphur diesel at Edmonton.

Capital Stock

On November 17, 2005 Utility Group issued 7,799,895 common shares in exchange for the outstanding shares of AUHI, and 390,000 common shares in an Initial Public Offering for net proceeds of $2.7 million. Utility Group declared dividends of $0.03 per quarter to its shareholders in 2006, resulting in the payment of $0.7 million in 2006. The Board of Directors declared a dividend of $0.035 per common share payable on April 16, 2007 to shareholders of record on March 30, 2007, an increase of $0.005 per common share per quarter over 2006 levels.

IX. OFF-BALANCE SHEET ARRANGEMENTS

Utility Group is not party to any contractual arrangement under which an unconsolidated entity may have any obligation under certain guarantee contracts, a retained or contingent interest in assets transferred to an unconsolidated entity or similar arrangement that serves as credit, liquidity or market risk support to that entity for such assets. Utility Group has no obligation under derivative instruments, or a material variable interest in an unconsolidated entity that provides financing, liquidity, market risk or credit risk support to the registrant, or engages in leasing, hedging or research and development services with the registrant.

X. DISCLOSURE CONTROLS AND PROCEDURES

Utility Group maintains disclosure controls and procedures designed to ensure that information required to be disclosed in reports filed or submitted under the Securities Act (Ontario) is accumulated and communicated to management, including the President and Chief Executive Officer and the Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.

In accordance with Multilateral Instrument 52-109 (Certification of Disclosure in Issuers' Annual and Interim Filings), an evaluation was conducted under the supervision and with the participation of management, including the President and Chief Executive Officer and the Chief Financial Officer, of the effectiveness of the disclosure controls and procedures as of the end of the period covered by this report. Based on that evaluation, the President and Chief Executive Officer and the Chief Financial Officer concluded that the disclosure controls and procedures were effective as of December 31, 2006 to provide reasonable assurance that information required to be disclosed is recorded, processed, summarized, and reported within the time periods specified in the Ontario Securities Commission's rules and forms.

XI. INTERNAL CONTROLS OVER FINANCIAL REPORTING

Management of Utility Group is responsible for establishing and maintaining adequate internal controls over financial reporting. All internal control systems, no matter how well designed, have inherent limitations. Therefore, even those systems determined to be designed effectively can provide only reasonable assurance with respect to financial statement preparation and presentation.

Utility Group has used the Committee of Sponsoring Organizations of the Treadway Commission (COSO) framework to evaluate the design of internal controls over financial reporting.

As at December 31, 2006 management assessed the design of Utility Group's internal control over financial reporting and concluded that internal control over financial reporting is suitably designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with GAAP and that there were no material weaknesses in the design of Utility Group's internal control over financial reporting that have been identified by management.

There have been no changes in the design of internal control over financial reporting during the year ended December 31, 2006 that have materially affected or are reasonably likely to materially affect its internal control over financial reporting.

XII. TRANSACTIONS WITH RELATED PARTIES

In 2006 Utility Group purchased natural gas from AltaGas Income Trust (the Trust) for $82.9 million (for the period November 17 to December 31, 2005 – $25.7 million). Utility Group also paid the Trust $0.5 million ($0.1 million – 2005) for operating services. The Trust purchased transportation for $0.6 million ($0.1 million – 2005) and administrative, management and other services of $0.5 million services from Utility Group (nil – 2005).

In 2006 Utility Group purchased natural gas from the Ikhil Joint Venture for $1.2 million (for the period November 17 to December 31, 2005 – $0.2 million), and the Ikhil Joint Venture in turn paid Utility Group $0.5 million ($46,000 – 2005) for administration, management and other services.

There is an Administrative Service Agreement between the Trust and Utility Group whereby the Trust provides certain administrative and support services to Utility Group until December 31, 2007, and which may be extended by mutual agreement of the parties. The Trust will receive $30,000 per year for the services provided.

See Notes to the consolidated financial statements.

XIII. CRITICAL ACCOUNTING ESTIMATES

Since a determination of the value of many assets, liabilities, revenues and expenses is dependent upon future events, the preparation of Utility Group's consolidated financial statements requires the use of estimates and assumptions which have been made using careful judgment by management. Management has discussed the development and selection of these critical accounting estimates with the Audit and Governance Committee of the Board of Directors and its independent auditors, who have reviewed and approved Utility Group's disclosure relating to critical accounting estimates in this MD&A.

Effective April 1, 2006 the Canadian Institute of Chartered Accountants (CICA) adopted an abstract pertaining to conditional asset retirement obligations. Utility Group evaluated the abstract and determined that no change was required to its asset retirement obligation policy. The policy is described in the audited consolidated financial statements for the year ended December 31, 2006.

Utility Group's significant accounting policies are described in the Notes to the audited consolidated financial statements of Utility Group for the year ended December 31, 2006. The most critical of these policies with respect to estimates are those related to rate regulation, determination of pension and other employee benefits, amortization and depreciation expense, goodwill impairment assessment and asset retirement obligation. Actual results may differ from these estimates.

The financial statements for the period have been prepared in accordance with the accounting policies described in the notes thereto. The main areas where changes in estimates and assumptions could have a material impact on financial results in future periods are as follows:

Rate Regulation

AUI's and Heritage Gas' accounting policies are subject to examination and approval by their respective regulators. As a result, their rate-regulated accounting policies may differ from accounting policies for non-rate-regulated companies. These differences occur when the regulators render their decisions on rate applications and generally involve the timing of revenue and expense recognition.

The accounting for these items is based on management's expectation of the future actions of the regulators. For example, AUI does not record future income taxes as the taxes payable method is prescribed by the EUB for rate-making purposes and there is reasonable expectation that the EUB will provide for all such future income taxes to be recovered in rates when they become payable. Similarly, the deferral of differences between the amounts included in rates and the actual experience for specified expenses is based on management's expectation that the regulators will approve the refund to, or recovery from, ratepayers of the deferred balance.

If the regulators' future actions are different from management's expectations, the timing and amount of the recovery of liabilities and refund of assets, recorded or unrecorded, could be significantly different from that reflected in the financial statements.

Pension and Other Employee Benefits

AUI provides post-retirement benefits to employees, including a defined-benefit pension plan. The cost of providing these benefits is dependent upon many factors that result from actual plan experience and assumptions of future experience.

The benefit cost and accrued benefit obligation for employee future benefits included in annual compensation expenses are affected by employee demographics, including age, compensation levels, employment periods, contribution levels and earnings on plan assets.

Changes to the provisions of the plan may also affect current and future pension costs. Benefit costs may also be significantly affected by changes in key actuarial assumptions, including anticipated rates of return on plan assets and discount rates used in determining the accrued benefit obligation and benefit costs.

The pension plan assets include mainly equity and fixed income investments. Fluctuations in actual equity market returns and changes in interest rates may result in increased or decreased pension costs in future periods.

Amortization and Depreciation Expense

Amortization and depreciation of property, plant and equipment are provided on a straight-line basis over the estimated useful lives of the assets. Depreciation rates include an estimate of future removal and site restoration costs, as approved by the regulators. Actual removal and site restoration costs are charged to accumulated depreciation in accordance with regulatory treatment.

These depreciation rates are determined based on periodic depreciation studies conducted by an external consultant that makes an objective assessment of the useful lives of property, plant and equipment in use. The last such study conducted in respect of AUI was completed in 2004 and was filed as part of AUI's 2005/2006 GRA.

Goodwill Impairment Assessment

Goodwill represents that portion of the purchase price of the shares of AUHI, purchased on November 17, 2005, which was in excess of the fair market value of the identifiable assets acquired. Goodwill is tested at least annually for impairment by comparing the fair value of AUHI with its book value. Impairment charges will be recorded as impairment estimates are determined.

Asset Retirement Obligation

Certain of Utility Group's long-lived tangible assets are expected to have future legal obligations upon retirement. However, Utility Group has not recorded an asset retirement obligation due to the indeterminate life of its distribution and supply network and corresponding indeterminable timing and scope of asset retirements. An asset retirement obligation and offsetting capital asset will be recognized when the timing and amount can be reasonably estimated.

XIV. FOURTH QUARTER HIGHLIGHTS

Financial Results

Three Months Ended December 31	*Utility Group*		*AUHI*	
($ millions, except per share amounts or as otherwise noted)	**2006**	2005[1]	**2006**	2005
Revenue	**44.3**	30.5	**44.3**	57.4
Net revenue[2]	**11.4**	5.6	**11.4**	9.9
Operating and administrative	**5.6**	2.7	**5.3**	5.5
EBITDA[2]	**5.8**	2.9	**6.2**	4.4
Depreciation and amortization	**1.6**	0.9	**1.6**	0.8
Operating income[2]	**4.2**	2.0	**4.5**	3.6
Interest expense	**1.0**	0.4		
Income tax expense	**0.6**	0.3		
Net income	**2.6**	1.3		
Shares outstanding (thousands)				
Basic	**8,190**	8,190		
Diluted	**8,190**	8,200		
Net income per share – basic and diluted	**$ 0.32**	$ 0.15		
Customers at period end	**65,066**	62,854		
Degree day variance (percent)	**4.3**	(13.6)		

(1) The period ended December 31, 2005 includes operations of all acquired businesses since the completion of the acquisition of AUHI on November 17, 2005.

(2) Non-GAAP financial measure. See discussion in "Non-GAAP Financial Measures" section of this MD&A.

1. AltaGas Utility Group Inc. Fourth Quarter Discussion of Financial Results

Utility Group reported net income of $2.6 million for the three months ended December 31, 2006. A number of offsetting items resulted in net income being higher than anticipated by $0.2 million. Net revenue was lower than anticipated by $0.3 million due to regulatory decisions, partially offset by volume increases due to colder weather and new customers. Operating and administrative expenses were $0.3 million higher than anticipated. Depreciation rates adjusted by the EUB led to lower charges of $0.2 million and income tax expense was $0.6 million lower than anticipated.

Utility Group's revenue for the quarter ended December 31, 2006 of $44.3 million was $24.5 million lower than anticipated. The cost of natural gas flowed through to customers accounted for $20.6 million of the decrease, variances in regulatory decisions from expectations lowered revenue by $0.7 million, lower demand based revenues at AUI accounted for a $1.0 million reduction, and a shift of more customers to retail supply, with no revenue associated with cost of gas pass-through, lowered revenue by $2.5 million. These reductions were offset by an increase of $1.0 million attributable to colder than normal weather and $0.6 million due to higher growth in volumes related to an increase in service sites served.

Net revenue for the three months ended December 31, 2006 of $11.4 million was $0.3 million less than anticipated. Regulatory decisions lowered net revenue by $0.8 million, which was offset by $0.1 million due to colder than normal weather and higher usage and other differences accounted for $0.4 million.

Operating and administrative expenses for the three months ended December 31, 2006 of $5.6 million were $0.3 million greater than anticipated. Increased costs in labour and other administrative expenses of $0.3 million were a function of increased activity at AUI.

Depreciation and amortization charges of $1.6 million for the three months ended December 31, 2006 were $0.2 million less than anticipated and a function of changes in AUI's depreciation rates mandated by the EUB.

Income tax expense for the quarter ended December 31, 2006 of $0.6 million was $0.6 million less than anticipated. A reduction in tax due to lower tax rates accounted for $0.1 million, and $0.5 million was attributable to costs deductible for tax purposes being greater than for accounting purposes.

2. AltaGas Utility Holdings Inc. Fourth Quarter Discussion of Operating Results

Operating income for the quarter of $4.5 million was $0.9 million higher than in the fourth quarter of 2005. Higher net revenue was partially offset by depreciation and amortization charges.

Revenue for the quarter was lower than in the same quarter of 2005 by $13.1 million. AUI's cost of natural gas recovered was $21.6 million lower, partially offset by $6.3 million higher revenue related to colder weather in 2006 than in 2005, and $1.8 million higher due to increased usage.

Net revenue for the quarter was higher than in the same quarter of 2005 by $1.5 million or 14.9 percent. AUI contributed $1.1 million of the total, with $0.6 million due to colder weather and $0.2 million due to increased usage. Heritage Gas contributed $0.3 million to the increase, with a 335 percent increase in natural gas delivered to more than double the number of customers. Inuvik Gas contributed $0.1 million to the increase, with a 5.5 percent increase in natural gas deliveries.

Depreciation and amortization costs increased $0.8 million due to the additional amortization related to capital spending on system development at both Heritage Gas and AUI, and to system betterment at AUI.

XV. ALTAGAS UTILITY GROUP INC.

Summary of Most Recently Completed Quarters

Utility Group began operations on November 17, 2005. Results for the first financial reporting period include results of operations from November 17 to December 31, 2005.

Utility Group

	2006				2005
(Unaudited, $ millions)	Q4	Q3	Q2	Q1	Q4
Net revenue[1]	11.4	6.0	6.3	12.0	5.6
Operating income	4.2	(0.5)	(0.6)	5.7	2.0
Net income	2.6	(0.9)	(0.7)	3.2	1.3

	2006				2005
($ per share)	Q4	Q3	Q2	Q1	Q4
Net income					
Basic	0.32	(0.11)	(0.09)	0.40	0.15
Diluted	0.32	(0.11)	(0.09)	0.40	0.15
Dividends declared	0.03	0.03	0.03	0.03	–

(1) Non-GAAP financial measure. See "Non-GAAP Financial Measures" section of this MD&A.

Utility Group's natural gas distribution businesses' strong seasonality is reflected in the results of the five quarters it has operated. Utility Group's results are sensitive to differences in weather from "normal", due to the EUB and NSUARB's use of a rolling 20-year average temperature to set AUI's and Heritage Gas' rates. As shown in "Sensitivity Analysis", a 5 percent change in annual weather from normal can result in a change in net income of approximately $0.5 million. Results can also be affected by variances in customer usage from normal in response to factors that might decrease or increase typical usages. Shareholders, not rate payers, receive the benefit or incur the loss related to variances in volumes due to weather, conservation or other factors that impact customer consumption.

Regulatory decision making is another factor that tends to affect the pattern of Utility Group results. Both AUI and Heritage Gas estimate revenue until certain amounts are finalized pursuant to regulatory proceedings, which can have a significant time lag.

Significant items which impacted the quarterly earnings were as follows:

- Net income for the fourth quarter 2006 was $0.2 million above expectation; positively impacted by colder than normal weather and reduced income tax offset partially by variances in regulatory decisions and increased operating and administrative costs.
- In the third quarter of 2006 net revenue was lower than anticipated by $0.3 million due to a regulatory decision allowing lower than requested recoveries of operating and interest costs offset by lower depreciation and amortization and lower operating and administrative costs.
- Second quarter 2006 net income was affected by a regulatory decision allowing lower than requested recovery rates of interest costs, which reduced net income by $0.3 million.
- Net income for the first quarter of 2006 was affected by a change in the method of billing for the fixed charge components of AUI's delivery rates, which increased net income by $0.3 million.
- In the fourth quarter of 2005, the EUB issued Decision 2005-127 relating to AUI's 2005/2006 GTA and AUI reduced the accrued rate increase adjustments in accordance with the compliance filing. In the quarter, the weather was 14 percent warmer than normal, negatively impacting net income by $0.5 million.

XVI. RISKS AND UNCERTAINTIES

In the natural gas distribution business, where parties are subject to return on rate base regulation, rates are set to allow the regulated entity the opportunity to recover its costs and earn a reasonable return on a set capital structure. There is no guarantee that the entity will earn its allowed return because rates are set to cover future estimated costs and estimated demand is based on normal weather conditions. The entity's actual revenues may be more or less than forecast due to variations from normal weather, conservation and other factors which impact customer usage. Expenses and other revenues may also be higher or lower than forecast. Financial results for Utility Group are subject to a variety of risks including: regulation; franchise renewal; gas demand (including relating to weather, customer additions/mix, alternative energy sources and climate change); gas supply; environmental and safety; competition; physical; insurance; credit; contingencies; human resources; conflicts of interest; access to additional financing; and decommissioning, abandonment and reclamation costs.

XVII. SENSITIVITY ANALYSIS

The following table illustrates the anticipated effects of economic and operational changes on Utility Group's expected 2007 net income.

Factor	Increase or decrease	Impact on net income
Degree days[1]	5.0 percent	+ / - $0.5 million
Allowed rate of return on equity[2]	25 basis points	+ / - $0.1 million
Interest rates	25 basis points	+ / - $0.1 million
Increase in approved rate base	$2.5 million	+ / - $0.1 million
Recovery of costs in customer rates	$0.5 million	+ / - $0.3 million

(1) Degree day variance is a measure of the temperature of the geographic areas in which AUI operates, over the applicable period expressed in relation to normal degree days in that period. A degree day is the cumulative extent to which the daily mean temperature falls below 18 degrees Celsius. Normal degree days are based on a 20-year rolling average.

(2) The change in allowed rate of return on equity pertains only to the return on equity of AUI.

XVIII. PENDING ACCOUNTING PRONOUNCEMENTS

In April 2005, the Accounting Standards Board (AcSB) released three new handbook sections related to financial instruments and hedging, and one new handbook section dealing with the disclosure and presentation of financial instruments:

- Section 1530 Comprehensive Income;
- Section 3855 Financial Instruments – recognition and measurement;
- Section 3865 Hedges (section 3865); and
- Section 3861 Financial Instruments – Disclosure and Presentation.

The new standards were intended to harmonize Canadian GAAP with U.S. GAAP and with International Financial Reporting Standards. The standards are effective for fiscal years beginning on or after October 1, 2006.

Section 1530 establishes the standards for the reporting and display of other comprehensive income. Comprehensive income is the change in equity (net assets) of an enterprise during a period from transactions and other events and circumstances from non-owner sources. It includes all changes in equity during a period except those resulting from investments by owners and distribution to owners. Amounts recognized in other comprehensive income must eventually be reclassified into the income statement and these reclassifications are to be disclosed separately. Income tax expense and benefit associated with each component of other comprehensive income must also be disclosed. Other comprehensive income may be presented

immediately below net income on the income statement, in a separate statement that begins with new income, or in a statement of changes in equity. As Utility Group currently has no hedging instruments and will not be designating any financial assets as available for sale, Utility Group expects to have no adjustments recognized through other comprehensive income in 2007.

Section 3855 requires all financial assets and liabilities to be classified into specific categories by characteristic and/or management intent. The classification of the financial instruments determines how they are accounted for on an ongoing basis as the initial measurement for all financial instruments is fair value. Financial assets are to be classified into one of four categories as follows: held for trading, held to maturity, loans and receivable and available for sale. Financial liabilities are to be classified in one of two categories as follows: held for trading and other liabilities. The classification determines how the financial instruments are measured subsequent to initial recognition and how the gains and losses are recognized.

One principle of Section 3855 is that all financial instruments, including both financial and non-financial derivatives, are assets and liabilities. This has two main implications which are that all derivatives are to be recorded on the balance sheet, and derivatives that are embedded in non-derivative contracts must be separated and recognized accordingly. In addition, only assets and liabilities are to be recorded in the financial statements and fair value is the most relevant measure for financial instruments and the only measure for derivative financial instruments.

Utility Group reviews its contracts to identify embedded derivatives and it is expected that the value of any derivatives will not be material. Utility Group also has reviewed its financial instruments and expects to classify the financial assets as loans and receivables and the financial liabilities as other. Therefore, they would be recorded at amortized cost which will not be materially different than the carrying value of these items other than for debt.

Section 3865 establishes standards for when and how hedge accounting may be applied. Hedge accounting is optional. Utility Group currently has no hedges therefore this section is expected to have no impact in 2007.

Section 3861 establishes the disclosure and presentation requirements for financial instruments. The Utility Group expects to have additional disclosure requirements due to the implementation of this section.

Section 3251 Equity

Section 3251 establishes the standards for the presentation of equity and changes in equity during the period. The standard includes the disclosure of accumulated other comprehensive income which the Utility Group does not expect to have in 2007.

Rate-Regulated Operations Project

The AcSB recently considered the effects on its rate-regulated operations project of its recently adopted Strategic Plan and decided that the project, as originally planned, should be discontinued. It further decided, subject to exposure of its proposals, that: (i) the temporary exemption in Section 1100 of the CICA Handbook providing relief to entities subject to rate regulation from the requirement to apply the Section to the recognition and measurement of assets and liabilities arising from rate regulation should be removed; (ii) the explicit guidance for rate-regulated operations provided in Section 1600, *Consolidated Financial Statements*, Section 3061, *Property, Plant and Equipment*, Section 3465, *Income Taxes*, and Section 3475, *Disposal of Long-Lived Assets and Discontinued Operations*, should be removed; and (iii) Accounting Guideline 19, *Disclosures by Entities Subject to Rate Regulation*, should be retained as is. The Canadian AcSB also observed that relying on U.S. Statement of Financial Accounting Standards No. 71, *Accounting for the Effects of Certain Types of Regulation* (FAS 71), as another source of Canadian GAAP in the absence of CICA Handbook guidance addressing the specific circumstances of entities subject to rate regulation, is consistent with Section 1100 when the qualifying criteria of FAS 71 are met.

Utility Group is in the process of determining any implications this may have, as this project proceeds. No exposure draft has been issued to date.

XIX. OUTLOOK

1. Operations

In 2007 Utility Group's management expects that the three operating businesses will perform according to the business plans approved by their Boards and proposed to their regulators.

AUI will continue to pursue growth in its existing franchise areas and is well-positioned to capture opportunities arising in the areas around Edmonton, Alberta. The 1,963 new service additions in 2006 exceeded the 1,167 annual average additions of the preceding five years by 68 percent, the most added in any one year for at least the past 30 years. The busy Alberta economy has resulted in an unprecedented level of carry forward applications setting a foundation for a busy 2007. AUI is carrying forward 1,026 applications for service that were not installed in 2006; in comparison, AUI did not receive its 1,000th application for service until May in 2006 and until August in 2005.

AUI's rate base growth from 2005 to 2006 was 5.4 percent compared to simple average growth in the preceding five years of 2.3 percent. AUI has filed its 2007 GRA to grow its rate base by 7.6 percent from 2006 approved levels, anticipating that this higher than historical growth will continue. AUI capital expenditures net of CIAC for 2007 are expected to be approximately $12.0 million.

Heritage Gas' five-year development plan, filed with the NSUARB in early 2007, involves extending its reach and customer base gradually as the Nova Scotia markets embrace the benefits of natural gas. The plan forecasts that growth through 2011 will be in the Cumberland County and the Halifax Regional Municipality. Heritage Gas' development strategy continues to be to obtain anchor loads and other customer commitments sufficient to meet economic hurdles prior to undertaking system expansions.

In 2007 Heritage Gas will continue to build-out services in its franchise areas in Amherst and the County of Cumberland, and in the Dartmouth and airport areas of the Halifax Regional Municipality. Heritage Gas expects its Board of Directors to make a decision in early 2007 regarding the timing of the $18.0 million project to cross the Halifax Harbour to service downtown Halifax. Heritage Gas estimates capital expenditures for 2007 of $22.8 million, including the Harbour crossing, with Utility Group's share being $5.7 million.

In its December 2006 decision, the NSUARB confirmed Heritage Gas' capital structure at 55 percent debt and 45 percent equity, with an 8.75 percent debt return and a 13.0 percent equity return through 2011. During this period, Heritage Gas' development plan forecasts that rate base will approximately double from the $55.1 million at the end of 2006. The NSUARB also confirmed the ongoing use of an RDA account. Given prudent capital and operating expenditures, this ongoing use of an RDA account provides assurance of achieving the allowed returns during the development of this new natural gas franchise in Nova Scotia.

Inuvik Gas' presence north of the Arctic Circle positions it to capture possible growth as northern development occurs with the major pipeline projects bringing Alaskan and northern Canadian gas to market. Inuvik Gas' operation is relatively small, and while profitable, results are not expected to change materially in 2007.

Utility Group's results are sensitive to differences in weather from "normal", due to the EUB and NSUARB's use of a rolling multi-year average temperature to set AUI's and Heritage Gas' rates. Utility Group receives the benefit or loss related to variances in volumes due to weather, conservation or other factors that impact customer usage. Due to their relatively small size, weather variances for Heritage Gas and Inuvik Gas do not have a significant impact on the earnings of Utility Group.

Utility Group has an objective to grow the business, both through growth of its three operating businesses as outlined above, and through acquisitions of infrastructure-based utility businesses. Management evaluates acquisition opportunities on an ongoing basis, and will pursue opportunities that will provide accretive shareholder value.

2. Regulatory Proceedings

Utility Group expects that AUI and Heritage Gas will continue to be regulated by the governing provincial regulators under a return-on-rate base methodology and that Inuvik Gas will continue to operate in a "light handed" regulatory environment.

Utility Group's earnings can be significantly influenced by the regulatory allowed return on equity for AUI and Heritage Gas and variances from normal weather in the AUI franchise areas. The allowed return on equity for AUI is set annually by the EUB and has been set at 8.51 percent for 2007, compared to 8.93 percent in 2006 and 9.5 percent in 2005. The EUB sets return on equity using a formula based on the cost of long-term debt, and this method is in place through 2008. The allowed return on equity for Heritage Gas of 13.0 percent has been approved by the NSUARB through to December 31, 2011.

A number of applications have been filed with the EUB for approval and are pending decisions, as described earlier in this MD&A. Utility Group's expected results for 2007 may be impacted by decisions, particularly on Phase 1 of its 2007 general tariff application, and on the Review and Variance application requesting a review and change to the cost of debt allowed in EUB's decision 2006-049. To the extent that the forecast level of operating and administrative expenses or capital expenditures is not approved, income may be negatively impacted. To the extent that the cost of debt allowed is increased, income may be positively impacted. In addition, the estimates in the general tariff application are based upon detailed forecasts which are based upon numerous assumptions such as customer demand, weather, cost of labour and material, as well as other factors which could change and cause actual results to differ from these forecasts.

The impact of the EUB decisions cannot be determined at this time. When the EUB or NSUARB issues a decision affecting the financial statements, the effects of the decisions are recorded in the period in which the decision is received. However, if in management's judgement a reasonable estimate can be made regarding the impact an impending future decision will have on the current year's financial statements, an estimate will be recorded in the current year for the expected impact.

XX. SUBSEQUENT EVENTS

On January 8, 2007 Utility Group purchased an additional 270,412 common shares of Heritage Gas for $0.3 million and advanced $0.3 million under its long-term loan agreement.

On February 22, 2007 Utility Group purchased an additional 234,395 common shares of Heritage Gas for $0.2 million and advanced $0.5 million under its long-term loan agreement.

Contributions were also made by the other shareholders of Heritage Gas, resulting in no change to Utility Group's proportionate ownership share in Heritage Gas.

Management's Responsibility for Financial Statements

Management recognizes that it is responsible for the preparation of the consolidated financial statements and is satisfied that these statements have been prepared using Canadian generally accepted accounting principles and are within reasonable limits of materiality. Further, management is satisfied that the financial information contained in this annual report is consistent with that presented in the consolidated financial statements. AltaGas Utility Group Inc.'s internal controls and systems are designed to provide reasonable assurance that its assets are safeguarded and to facilitate the preparation of relevant, reliable and timely information. External auditors have been engaged by AltaGas Utility Group Inc. to examine the consolidated financial statements. The Audit and Governance Committee of the Board of Directors has reviewed these statements with the external auditors and management and has reported its findings to the Board. The Board of Directors, on the recommendation of the Audit and Governance Committee, has approved the consolidated financial statements contained in this report.

Patricia M. Newson

Patricia M. Newson
President and Chief Executive Officer
of AltaGas Utility Group Inc.
February 26, 2007

Dimitrios (Jim) Leonidas
Chief Financial Officer and Corporate Secretary
of AltaGas Utility Group Inc.
February 26, 2007

Auditors' Report

To the Shareholders of AltaGas Utility Group Inc.

We have audited the consolidated balance sheets of AltaGas Utility Group Inc. as at December 31, 2006 and 2005 and the consolidated statements of income and retained earnings and cash flows for the year ending December 31, 2006 and from the date of inception July 6, 2005, to December 31, 2005. These financial statements are the responsibility of Utility Group's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of AltaGas Utility Group Inc. as at December 31, 2006 and 2005 and the results of its operations and its cash flows for the year ending December 31, 2006 and from the date of inception, July 6, 2005 to December 31, 2005 in accordance with Canadian generally accepted accounting principles.

Ernst + Young LLP

Ernst & Young LLP
Chartered Accountants

Calgary, Canada
February 26, 2007

AltaGas Utility Group Inc.
Consolidated Balance Sheets

As at December 31 ($ thousands)	2006	2005
ASSETS		
Current assets		
Cash	$ 296	$ 381
Accounts receivable *(note 15)*	26,487	30,089
Inventory	231	269
Deferred cost of gas, net of taxes	1,057	1,552
Future income tax asset *(note 12)*	16	133
Prepaid expenses and deferred charges	1,434	1,292
	29,521	33,716
Property, plant and equipment *(notes 5 and 6)*	117,723	106,986
Goodwill *(note 5)*	31,575	31,575
Regulatory assets *(note 7)*	4,983	3,046
Future income tax asset *(note 12)*	87	–
Other assets *(note 8)*	142	166
	$ 184,031	$ 175,489
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities		
Short-term debt *(note 9)*	$ 2,221	$ –
Accounts payable and accrued liabilities *(note 15)*	28,955	33,222
Dividends payable	246	–
Income and other taxes payable	382	451
	31,804	33,673
Long-term debt *(note 9)*	83,157	77,164
Customer deposits and other liabilities	2,920	1,979
Future income tax liability *(note 12)*	99	119
	117,980	112,935
Shareholders' equity		
Share capital *(note 10)*	61,278	61,278
Contributed surplus *(note 10)*	257	7
Retained earnings	4,516	1,269
	66,051	62,554
	$ 184,031	$ 175,489

Commitments *(note 11)*

See accompanying notes to the consolidated financial statements

Approved by the Board of Directors of AltaGas Utility Group Inc.:

David W. Cornhill
Director

J. Bruce Petrie
Director

AltaGas Utility Group Inc.
Consolidated Statement of Income and Retained Earnings

For the year ended December 31, 2006 and from the date of inception on July 6 to December 31, 2005

($ thousands)	**2006**	2005
REVENUE *(note 15)*	**$ 130,864**	$ 30,450
EXPENSES *(note 15)*		
Cost of natural gas	**95,200**	24,869
Operating and administrative	**20,175**	2,665
Depreciation and amortization *(notes 6 and 7)*	**6,693**	941
	122,068	28,475
Operating income	**8,796**	1,975
Interest expense	**3,566**	359
Income before income taxes	**5,230**	1,616
Income taxes *(note 12)*		
Current income taxes	**989**	397
Future income taxes	**11**	(50)
	1,000	347
Net income	**4,230**	1,269
Retained earnings, beginning of period	**1,269**	–
Dividends declared	**(983)**	–
Retained earnings, end of period	**$ 4,516**	$ 1,269
Net income per share *(note 10)*		
Basic	**$ 0.52**	$ 0.15
Diluted	**$ 0.51**	$ 0.15

See accompanying notes to the consolidated financial statements

AltaGas Utility Group Inc.
Consolidated Statement of Cash Flows

For the year ended December 31, 2006 and from the date of inception on July 6 to December 31, 2005

($ thousands)	2006	2005
CASH FROM OPERATIONS		
Net income	$ 4,230	$ 1,269
Items not involving cash:		
Revenue deficiency accrual	(1,222)	(95)
Allowance for funds used during construction *(note 6)*	(417)	(76)
Depreciation and amortization *(notes 6 and 7)*	6,693	941
Operating and administrative	1,009	4
Future income taxes	11	(97)
Other	301	7
Funds generated from operations	10,605	1,953
Net change in non-cash working capital *(note 13)*	(1,884)	(4,660)
	8,721	(2,707)
INVESTING ACTIVITIES		
Additions to property, plant and equipment	(19,148)	(2,216)
Contributions in aid of construction	3,476	(586)
Proceeds on disposition of property, plant and equipment	200	16
Investment in regulatory and other assets	(1,752)	(329)
Business acquisition *(note 5)*	–	(72,194)
	(17,224)	(75,309)
FINANCING ACTIVITIES		
Increase in short-term debt	2,221	–
Increase in long-term debt	5,993	75,650
Net proceeds from issuance of common shares	–	2,705
Dividends paid	(737)	–
Increase in customer deposits and other liabilities	941	42
	8,418	78,397
Change in cash	(85)	381
Cash, beginning of period	381	–
Cash, end of period	$ 296	$ 381

See accompanying notes to the consolidated financial statements

Notes to the Consolidated Financial Statements

For the year ended December 31, 2006 and from the date of inception on July 6 to December 31, 2005

(tabular amounts in thousands of Canadian dollars unless as otherwise indicated)

1. STRUCTURE AND NATURE OF OPERATIONS

AltaGas Utility Group Inc. was incorporated with nominal capital under the Canada Business Corporations Act as 6414958 Canada Limited on July 6, 2005 and filed a certificate of amendment to change its name to AltaGas Utility Group Inc. (Utility Group) on July 28, 2005. Utility Group began active operations with the acquisition of all the issued and outstanding common shares of AltaGas Utility Holdings Inc. (AUHI) on November 17, 2005.

AUHI, through its ownership interests in AltaGas Utilities Inc. (AUI), AltaGas Utility Holdings (Nova Scotia) Inc. (AUH(NS)) and Inuvik Gas Ltd. (Inuvik Gas), holds interests in regulated natural gas distribution utility businesses operating in Alberta, Nova Scotia and the Northwest Territories, respectively. AUI and AUH(NS) are wholly owned subsidiaries of AUHI, while Inuvik Gas is one-third owned by AUHI. AUH(NS) owns a 24.9 percent interest in Heritage Gas Limited (Heritage Gas). The investments in Inuvik Gas and Heritage Gas are each jointly controlled by AUHI, along with their other shareholders.

AltaGas Utility Holdings Inc.

AUHI was incorporated under the laws of Canada on May 12, 1998.

AltaGas Utilities Inc.

AUHI acquired AUI on June 30, 1998. AUI is incorporated under the laws of Canada. AUI and its predecessor entities have been operating since 1954 as a provincially regulated natural gas distribution utility serving more than 90 communities in Alberta. AUI is regulated by the Alberta Energy and Utilities Board (EUB).

AltaGas Utility Holdings (Nova Scotia) Inc.

AUH(NS) was incorporated under the laws of Alberta on September 16, 2002. AUH(NS) sole investment is a 24.9 percent interest in Heritage Gas.

Heritage Gas Limited

Heritage Gas was incorporated under the laws of Canada on August 13, 2002. Its shareholders and their respective ownership interests are as follows:

SaskEnergy Nova Scotia Holdings Ltd.	50.1 percent
Silgascorp Inc.	25.0 percent
AltaGas Utility Holdings (Nova Scotia) Inc.	24.9 percent

On August 16, 2002 Heritage Gas filed an application for the right to distribute natural gas to certain counties in Nova Scotia. On February 7, 2003 the Nova Scotia Utility and Review Board (NSUARB) granted Heritage Gas a full regulation class franchise for a period of 25 years and in December 2003 issued a license to operate. Heritage Gas activated its natural gas distribution system on December 20, 2003.

Inuvik Gas Ltd.

Inuvik Gas was incorporated under the laws of Canada on February 21, 1997. The shareholders are AUHI, Inuvialuit Petroleum Corporation and IPL Holdings Inc. and each has an equal ownership interest.

Inuvik Gas owns and operates the natural gas distribution system serving the Town of Inuvik in the Northwest Territories and is regulated by the Northwest Territories Public Utilities Board (NWTPUB). Inuvik Gas was in a pre-operating construction phase from 1999 through to November 2000 and commenced commercial operations on December 1, 2000.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

These consolidated financial statements include the accounts of Utility Group and all of its wholly owned subsidiaries and its proportionate interests in Heritage Gas and Inuvik Gas from the date of acquisition of AUHI on November 17, 2005. Transactions between Utility Group, wholly owned subsidiaries and the proportionately consolidated entities are eliminated on consolidation.

These consolidated financial statements are prepared by management in Canadian dollars in accordance with Canadian generally accepted accounting principles (GAAP). The preparation of these financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses for the periods presented.

Regulation

AUI and Heritage Gas engage in the delivery and sale of natural gas and are regulated by the EUB and the NSUARB, respectively. The EUB and NSUARB exercise statutory authority over matters such as tariffs, rates, construction, operations, financing, returns, accounting and certain contracts with customers. In order to recognize the economic effects of the actions and decisions of the EUB and NSUARB, the timing of recognition of certain assets, liabilities, revenues and expenses as a result of regulation may differ from that otherwise expected using Canadian GAAP for entities not subject to rate regulation.

Inuvik Gas is subject to light-handed regulation by the Northwest Territories Public Utilities Board (NWTPUB), whereby rates are set by Inuvik Gas based on a competitive market place. The NWTPUB is satisfied that competition for alternative fuel exists in Inuvik and that competition is sufficient to negate the need for full regulation. Inuvik Gas is required to file its rates, terms and conditions of service with the NWTPUB when they are revised. The NWTPUB can take action should any complaints be received and may review the affairs, earnings and accounts of Inuvik Gas as it deems necessary.

For a description of financial statement effects of rate regulation see note 3.

Cash

Cash consists of cash on hand and balances with banks.

Inventory

Inventories of pipe, fittings and other materials used in construction and operations are valued at the lower of average cost and replacement cost.

Property, Plant and Equipment

Property, plant and equipment are recorded at cost, including certain overhead and administrative expenses attributable to construction and an imputed carrying cost incurred during the construction period to finance long-term construction projects as approved by the regulating authorities. AUI and Heritage Gas capitalize an imputed carrying cost on assets during construction as authorized by regulating authorities and the amount so capitalized is disclosed in Note 6 to the financial statements as allowance for funds used during construction (AFUDC). AFUDC is the amount that a rate-regulated enterprise is allowed to recover for its cost of financing assets under construction. It is calculated as the mid-year cost of construction work-in-progress multiplied by the regulated percentage cost of capital. Capitalized overhead, administrative expenses and AFUDC are included in the cost of the related assets and are recovered in future periods through depreciation charges.

Additions to property, plant and equipment are sometimes made with the assistance of contributions in aid of construction (CIAC) from the provincial governments and customers, where the estimated revenue is less than the cost of providing service or where special facilities are required to supply customers' specific needs. CIAC is recorded as a reduction of the corresponding asset balances. Amortization of CIAC is provided at rates that correspond with the depreciation of the related asset and is offset against the accumulated depreciation of the corresponding asset. Some portion of CIAC may be refundable. When refunded by AUI, the amount is then added to rate base.

For AUI and Heritage Gas, depreciation of property, plant and equipment is provided, subject to the approval of regulatory authorities, on a straight-line basis or over the contract term of a specific agreement. Depreciation rates are subject to periodic review and revision as part of the rate setting process. Any change in rates affects the current period's depreciation expense and the amount that can be recovered by the regulated business in its revenues. Rates for both AUI and Heritage Gas are:

	2006	2005
Transmission and distribution systems	**0.85 to 23.82 percent**	0.85 to 23.82 percent
Buildings, equipment and administrative	**3.10 to 35.71 percent**	3.10 to 35.71 percent
Other	**10.90 percent**	10.90 percent

For Inuvik Gas, depreciation of property, plant and equipment is provided on a straight-line basis over the estimated useful life of the assets as follows:

Distribution system	40 years
Computers	6 years
Other	3 to 10 years

Utility Group's natural gas transmission and distribution network comprises mains, service lines and measuring and regulating equipment and facilities. The depreciation rates include a provision for future removal and site restoration costs as required by the regulating authorities. Accumulated amortization includes the accumulated effect of the future removal and site restoration costs included in the depreciation rates. On retirement of depreciable assets, accumulated depreciation is charged with the cost of the retired unit, disposal and site restoration costs less salvage as required by the regulating authorities. Under GAAP for entities not subject to rate regulation, the depreciation rates would include no amount with respect to future removal and site restoration costs. In addition, differences between the proceeds of disposal and the asset's net book value would be recognized as a gain or loss during the period of disposal.

Asset Retirement Obligation

Certain of Utility Group's long-lived tangible assets owned by its subsidiaries and operating affiliates will have future legal obligations on retirement. However, Utility Group has not recorded an asset retirement obligation due to the indeterminate life of its distribution and supply network and corresponding indeterminable timing and scope of asset retirements. An asset retirement obligation and offsetting capital asset will be recognized when the timing and amount can be reasonably estimated.

Goodwill

Goodwill represents that portion of the purchase price of the shares of AUHI, purchased on November 17, 2005, which was in excess of the fair market value of the identifiable assets acquired. Goodwill is carried at initial cost less any write-down for impairment. In the last quarter of each fiscal year and as economic events dictate, management reviews the valuation of goodwill, taking into consideration any events or circumstances which might have impaired the fair value.

Stock-based Compensation

Utility Group follows the fair value method of accounting for share options granted during the year. Share options are valued at the date of the grant and recognized as compensation expense over the vesting period of the options. Consideration received by Utility Group on exercise of the option rights is credited to shareholders' capital.

Revenue Recognition

Revenues include revenue from the delivery of natural gas and recovery of the cost of gas paid to suppliers and of the associated gas supply costs. Utility Group's businesses recognize revenues when gas has been delivered or services have been performed. Gas distribution revenues are recorded on the basis of regular meter readings and estimates of usage since the last meter reading to the end of the reporting period. AUI and Heritage Gas recognize revenue in a manner that is consistent with the underlying rate-setting mechanism mandated by the regulating authorities.

Pension Plans and Retirement Benefits

The cost of the defined benefit pension and other retirement benefit plans are actuarially determined using the projected benefit method prorated on service and management's best estimate of expected plan investment performance, salary escalation, retirement ages of employees and other cost escalation and actuarial factors.

For purposes of calculating the expected return on plan assets, those assets are valued at fair value. The measurement date for the plan assets and obligations coincides with the fiscal year-end date of December 31. Obligations are attributed to the period beginning on the employee's date of joining the plan and ending on the earlier of the date of termination, death or retirement.

The cumulative unamortized net actuarial gain or loss at the beginning of the year in excess of 10 percent of the greater of the accrued benefit obligation and the fair value of plan assets is amortized on a straight-line basis over the average remaining service life of the active employees. The average remaining service periods of the active members covered by the pension plans and other retirement benefit plans are 14 to 16 years. Past service costs resulting from plan amendments are amortized on a straight-line basis over the average remaining service life of active employees for the respective plan. Transitional obligations are amortized on a straight-line basis over the remaining service life of active employees at the time the transitional obligations arose (15 years, ending December 31, 2014).

The other retirement benefit plans are funded on a cash basis as benefits are paid. No assets have been segregated or restricted to provide for the cost of the other benefits.

Income Taxes

Income taxes for AUI and Heritage Gas, except for that applied to the deferred cost of gas, are recovered from customers when paid and are provided for using the taxes payable method approved by the regulatory authorities. Therefore, provision is made only for those income taxes currently payable. No future tax is recorded by AUI and Heritage Gas on the differences between the financial reporting and tax basis of assets and liabilities as would be required by GAAP for non-regulated entities since it is anticipated that such taxes will be recovered through future rates. GAAP requires the liability method in recognition of future tax liabilities and future tax assets in the absence of rate regulation (note 12). Future income taxes related to the temporary difference between the tax basis of the deferred cost of gas and its carrying amount are netted against the carrying value of the related asset or liability presented on the balance sheet.

The liability method of tax accounting is used for Inuvik Gas and other non-regulated activities of Utility Group. Under this method, future income tax assets and liabilities are determined based on differences between the financial reporting and tax bases of assets and liabilities, and are measured using the substantively enacted tax rates and laws that are anticipated to be in effect in the periods in which the differences are expected to be settled or realized.

Earnings per Share

Basic and diluted earnings per share have been determined by dividing the consolidated net income for the period by the basic and diluted weighted average number of shares, respectively.

The diluted weighted average number of shares outstanding is calculated as if all dilutive options have been exercised at the later of the beginning of the reporting period or the date of grant, using the treasury stock method, which deems that proceeds from the exercise of such dilutive options to be used to repurchase common shares at the average market price for the period.

Segmented Information

Utility Group reports its financial results of operations as one reportable segment.

3. FINANCIAL STATEMENT EFFECTS OF RATE REGULATION

Utility Group accounts for certain transactions in accordance with applicable regulation (regulatory accounting) which may be different than it would be in the absence of rate regulation, namely the timing of recognition of certain assets, liabilities, revenues and expenses. This results in the creation of regulatory assets and liabilities.

Through the rate setting process, certain expenses and credits are deferred as assets and liabilities on the balance sheet until the time they are recovered from or refunded to customers. Regulatory assets represent future revenues associated with certain costs, incurred in the current period or in prior periods that will be recovered from customers in future periods through the rate setting process. Regulatory liabilities represent future reductions or limitations of increases in revenue associated with amounts that are to be refunded to customers through the rate setting process.

When the EUB or NSUARB issues a decision affecting the financial statements, the effects of the decision are recorded in the period in which the decision is received. However, if in management's judgement a reasonable estimate can be made regarding the impact a pending decision will have on the current year's financial statements, an estimate will be recorded in the current year for the expected impact.

Return on Rate Base

The EUB has established a formula in determining the rate of return on equity and capital structure for all gas and electric utilities under its jurisdiction, including Utility Group. AUI's current regulated capital structure was set at 59 percent debt and 41 percent equity by the EUB until 2009. Using the EUB-approved formula, the return on equity for 2006 was set at 8.93 percent (2005 – 9.5 percent).

The NSUARB has granted Heritage Gas a regulated rate of return of 13 percent on a 45 percent equity component and an 8.75 percent cost of shareholder debt on a 55 percent debt component of its capital structure until December 31, 2011.

Regulatory Process – Delivery Tariffs

AUI's and Heritage Gas' delivery tariffs are designed to recover AUI's and Heritage Gas' total cost of service and include an approved return on equity. Tariffs are determined through a two-phase General Tariff Application (GTA). Phase 1 establishes the revenue requirement and Phase 2 sets the rates to be charged to various customer classes.

AUI seeks approval of its revenue requirement through a negotiated settlement process with interested parties or through an administrative hearing before the EUB. The EUB monitors the negotiated settlement process and EUB approval is required for any settlement AUI reaches with interested parties. Factors affecting AUI's revenue requirement include forecasts for rate base, distribution and other revenue, gas costs, operating costs, depreciation, financing costs, income taxes and return on rate base. Heritage Gas uses an administrative hearing for the two phases of the regulatory process.

Although the approved revenue requirement and subsequent approved rates are based on forecasts, and actual results can differ from these forecasts, no adjustment is made to either the revenue requirement or rates for actual results varying from forecast. Once the rates are approved for a period, all risks and benefits from differences in actual versus forecast energy units delivered, capital expenditures, numbers of service sites billed, customer usage, operating costs, debt servicing costs and taxes are borne by the utility's shareholders. Actual returns achieved can therefore differ from allowed returns.

Regulatory Process – Gas Cost Recovery Rate (GCRR)

The GCRR is charged to consumers for gas supply and is designed to allow AUI and Heritage Gas to recover the market-determined price paid for natural gas without any mark-up. The EUB and NSUARB have established a framework for AUI and Heritage Gas to file their costs monthly with the EUB and NSUARB respectively. The EUB reviews AUI's GCRR applications to ensure that only the actual cost of gas is passed on to consumers. Once verified by the EUB, interested parties have 30 days to file any objections to the rate. The NSUARB has established that it does not have jurisdiction over setting the GCRR and therefore Heritage Gas advises the NSUARB of the new price for the following month.

AUI and Heritage Gas each establish what its GCRR should be each month by forecasting consumption. The forecast price is then determined using published indices. In addition to gas purchases, the GCRR includes estimated gas supply-related management and administration costs that are incurred by AUI, such as transportation costs, gas supply-related bad debts, and gas supply-related cash working capital costs.

During the course of the month, energy costs may vary from the forecast because of changes in demand and market price. In order to reconcile what customers are charged through the cost of gas rate with actual gas costs, any surpluses or deficits are accumulated in a deferred gas account. Any balance in the deferred gas account at the end of a month is included when determining the cost of gas for a subsequent period.

Accounting Policies Impacted by Rate Regulation

Cost of Natural Gas Sales

Cost of natural gas sales included in customer rates for AUI and Heritage Gas is based on the forecast cost of natural gas. Variances between forecast cost and actual cost of natural gas are deferred for refund to, or collection from, customers through adjustments to future rates. For both AUI and Heritage Gas, such adjustments occur in the following month.

Cost of natural gas sales for Inuvik Gas is based on market rates and there is no cost pass-through mechanism.

Regulatory Assets

Deferred Charges

Certain charges connected with costs of regulation are recorded at cost, deferred and amortized as approved by the regulator. The recovery or settlement period, or likelihood of recovery or settlement, of deferred charges is affected by the ultimate treatment by the regulator in the rate-setting process. There is risk and uncertainty that the regulator may not allow full recovery of recorded regulated assets.

Revenue Deficiency Account

Heritage Gas has approval from the NSUARB to use a Revenue Deficiency Account (RDA). The RDA changes based on the difference between the actual revenue billed and the revenue required to earn the rates of return approved by the NSUARB. In Heritage Gas' customer development stage, it is expected that the actual revenue billed will be less than the revenue required to earn the approved rates of return and therefore an RDA asset will accumulate. As the distribution network matures, the actual revenue billed is expected to exceed the revenue required to earn the approved rates of return, and the RDA will be drawn down.

In a year where a GTA has been filed but no decision has been issued, AUI accrues a revenue deficiency equivalent to the difference between the sales revenue expected to be received under its proposed GTA and the sales revenues at current approved rates. When the EUB issues a decision respecting the GTA, AUI finalizes its accrual based on the approved revenue requirement and the revenue forecast to be collected at current approved rates and collects the revenue deficiency by way of a deficiency rate rider. The AUI accrual is included in accounts receivable.

For entities not subject to rate regulation, GAAP does not provide for the accrual of a revenue deficiency. Revenue would be recognized based on amounts charged to customers during the period.

Estimates

Certain estimates are also necessary since the regulatory environment in which Utility Group's subsidiaries and affiliates operate often require amounts to be recorded at estimated values until these amounts are finalized pursuant to regulatory decisions, or other regulatory proceedings. Due to the inherent uncertainty involved in making estimates, these estimates are subject to measurement uncertainty and may impact the financial statements of future periods.

4. FINANCIAL INSTRUMENTS

Financial instruments that subject Utility Group to credit risk consist primarily of accounts receivable. Accounts receivable credit risk is reduced due to a large and diversified customer base, customer deposits for at-risk customers and the ability to recover the majority of uncollectible accounts through customer rates.

The carrying value of the current financial assets and liabilities of Utility Group approximate their fair value due to their short period to maturity. The carrying value of long-term debt also approximates fair value. The fair value of long-term debt is estimated using discounted cash flows based on current rates of interest.

Utility Group draws on its revolving term credit facility to fund its operations with floating rate debt, which exposes Utility Group to changes in interest payments due to fluctuations in interest rates.

5. ISSUANCE OF SHARES AND BUSINESS ACQUISITION

On November 17, 2005 Utility Group issued 7,799,895 common shares from its treasury to acquire from AltaGas Income Trust (the Trust) all the issued and outstanding common shares of AUHI. The Trust concurrently distributed 3,899,895 shares of Utility Group to its unitholders and sold 1,716,000 shares to the public in a secondary offering and Utility Group completed an offering of 390,000 shares at a price of $7.50 per share for gross proceeds of $2.9 million.

Given the resultant substantial change in effective ownership of AUHI, the acquisition of AUHI is treated as a business combination at fair market value at November 17, 2005 and is accounted for using the purchase method.

Net Assets Acquired		2005
Cash	$	2,515
Other current assets		26,068
Property, plant and equipment		105,054
Goodwill		31,575
Other assets		6,096
Current liabilities		(31,327)
Long-term debt		(4,679)
Other liabilities		(2,093)
	$	133,209
Consideration		
Cash	$	74,709
Shares issued		58,500
	$	133,209

6. PROPERTY, PLANT AND EQUIPMENT

		2006	
	Cost	Accumulated depreciation and amortization	Net book value
Transmission and distribution systems	**$ 162,895**	**$ 61,173**	**$ 101,722**
Buildings, equipment and administrative	**26,619**	**10,925**	**15,694**
Other	**916**	**609**	**307**
	$ 190,430	**$ 72,707**	**$ 117,723**

		2005	
	Cost	Accumulated depreciation and amortization	Net book value
Transmission and distribution systems	$ 149,609	$ 57,805	$ 91,804
Buildings, equipment and administrative	24,737	9,872	14,865
Other	789	472	317
	$ 175,135	$ 68,149	$ 106,986

Included in transmission and distribution systems and buildings, equipment and administrative at December 31, 2006 was work-in-progress in the amount of $5.0 million (December 31, 2005 – $3.1 million).

Net additions to property, plant and equipment are not depreciated until the year after they are brought into active service as required by the regulating authorities. Net additions to property, plant and equipment that were not depreciated during the period were $13.6 million (2005 – $0.5 million).

Utility Group capitalized $2.5 million of operating, administration and maintenance expenses during 2006 (2005 – $0.3 million), and AFUDC of $0.4 million during 2006 (2005 – $0.1 million).

7. REGULATORY ASSETS

Regulatory assets are recorded based on the expectation that amounts held from one period to the next for rate setting purposes will be approved for collection from customers in future periods. The recovery or settlement period, or likelihood of recovery or settlement of regulatory assets, is affected by the ultimate treatment by the regulator in the rate-setting process. There is risk and uncertainty that the regulator may not allow full recovery of recorded regulatory assets.

	2006		
	Cost	Accumulated amortization	Net book value
Deferred charges			
Deferred CEO/CFO certification costs	**$ 1,002**	**$ 157**	**$ 845**
Deferred regulatory costs	**1,344**	**1,182**	**162**
Future recovery of other retirement benefits	**1,408**	**–**	**1,408**
	3,754	**1,339**	**2,415**
Revenue deficiency account	**2,568**	**–**	**2,568**
	$ 6,322	**$ 1,339**	**$ 4,983**

	2005		
	Cost	Accumulated amortization	Net book value
Deferred charges			
Deferred CEO/CFO certification costs	$ 235	$ 32	$ 203
Deferred debt costs	48	–	48
Deferred regulatory costs	510	172	338
Future recovery of other retirement benefits	1,111	–	1,111
	1,904	204	1,700
Revenue deficiency account	1,346	–	1,346
	$ 3,250	$ 204	$ 3,046

Deferred Charges

AUI incurred costs to meet CEO/CFO certification requirements for reporting issuers as mandated by the Canadian Securities Administrators. The costs were forecast and included in 2005/2006 allowed rates. Differences between forecast and actual costs in the 2005/2006 rate years are deferred as a regulatory asset until the following GRA, when their final disposition is decided. AUI intends to seek, and expects to receive, approval for recovery of costs in the 2007 rate hearing. In the absence of rate regulation, GAAP would require that actual CEO/CFO certification costs be recognized as an expense when incurred. In this case, operating income for 2006 would have been $0.6 million lower (2005 – $0.1 million lower).

For AUI's rate-setting purposes, differences between interest rates approved on an interim basis and actual interest rates are held as a regulatory asset until the EUB rules on their final disposition. Debt costs were included in 2005/2006 allowed rates on an interim basis using forecast interest rates. During 2006 the EUB issued a decision disallowing the deferred debt costs of $48,500 recorded in 2005. The balance was expensed in 2006 as interest on long-term debt. In the absence of rate regulation, GAAP would require that actual costs be recognized as an expense when incurred. In this case, operating income for 2006 would have been $48,500 higher (2005 -- $48,500 lower).

For rate-setting purposes, differences between forecast and actual costs of regulatory proceedings are held as a regulatory asset until the EUB rules on their final disposition. Regulatory costs are included in 2005/2006 allowed rates on an interim basis using forecast costs. AUI intends to seek, and expects to receive, EUB approval for recovery of AUI's deferred regulatory costs in the 2007 rate hearing. Heritage incurred costs related to regulatory proceedings in 2004 and in 2006.

These costs are being amortized on a straight-line basis over a five-year period as approved by the NSUARB. In the absence of rate regulation, GAAP would require that actual regulatory costs be recognized as an expense when incurred. In this case, operating income for 2006 would have been $0.2 million higher (2005 – $0.1 million lower).

Other retirement benefits are accounted for on an accrual basis in accordance with the Canadian Institute of Chartered Accountants Handbook Section 3461. For regulatory purposes, these other retirement benefits costs are recoverable from customers based on AUI's funding of the costs. The revenue associated with the difference between the accrued costs and the funded costs is accrued and will be recovered from customers in future periods. In the absence of rate regulation, GAAP would require that the accrued revenue be recognized in the period earned. Consequently, operating income is $0.3 million higher (2005 – $30,600 higher) than would be the case in the absence of rate regulation.

Revenue Deficiency Account

Note 3, Financial Statement Effects of Rate Regulation, describes the Revenue Deficiency Account. The RDA at December 31, 2006 was $2.6 million (2005 – $1.3 million). The effect of the RDA accumulation was to increase 2006 revenue by $1.3 million (2005 – $0.1 million).

8. OTHER ASSETS

	2006	2005
Deferred bank charges (net of amortization 2006 – $27; 2005 – $4)	**$ 117**	$ 116
Other assets	**25**	50
	$ 142	$ 166

Deferred bank charges are being amortized on a straight-line basis over a five-year period.

9. DEBT

Short-term Debt

On November 17, 2005 Utility Group entered into an unsecured uncommitted demand operating credit facility with a Canadian chartered bank for $10.0 million. Borrowings on the facility can be by way of prime rate loans, U.S. base rate loans, letters of credit, bankers' acceptances and LIBOR loans. Prime rate loans drawn as at December 31, 2006 were $2.2 million (2005 – nil).

In September 2004 Heritage Gas obtained a $1.0 million (Utility Group's proportionate interest – $0.2 million) demand credit facility from a Canadian chartered bank. It is secured by a General Security Agreement on the property of Heritage Gas and bears interest at prime plus 1 percent. Borrowings on the facility are by way of loans bearing interest at the bank's prime rate, or by way of letters of credit or letters of guarantee for a fee. To date there have been no draws on the facility.

Effective 2003 Inuvik Gas held a $0.5 million revolving demand credit facility with one of its affiliates. The borrowings had a prevailing interest rate of prime plus 1 percent. On December 4, 2006, the credit facility expired. No draws were ever made on the credit facility. In December 2006 the affiliate committed to provide Inuvik Gas with a revolving demand loan of up to $0.5 million (Utility Group's proportionate interest – $0.2 million) with a prevailing interest rate of prime plus 1 percent. Borrowings under this facility are at the option of Inuvik Gas and may be made to December 17, 2007. To date there have been no draws on this facility.

Long-term Debt

Utility Group funds its long-term borrowing requirements with a credit facility from a syndicate of Canadian chartered banks and from the Province of Nova Scotia.

Facility	Maturity	Interest rate	2006	2005
Revolving, term credit facility	November 2009	4.89%[(1)]	$ 81,763	$ 75,770
Loan from Province of Nova Scotia	July 2014	See note below	1,394	1,394
			$ 83,157	$ 77,164

(1) Average bankers' acceptance rate for outstanding bankers' acceptances at December 31, 2006 (2005 – 3.94%).

On November 17, 2005 Utility Group entered into an unsecured extendible revolving credit facility with a syndicate of Canadian chartered banks for $100.0 million with a term to November 17, 2008. The maturity date is extendible upon consent of each lender for further successive one-year periods. On October 19, 2006, the lenders granted Utility Group a one-year extension to November 17, 2009. Borrowings on the facility can be by way of prime rate loans, U.S. bank rate loans, letters of credit, bankers' acceptances and LIBOR loans. All borrowings under this facility have been in the form of bankers' acceptances.

In 2005, Heritage Gas received $7.6 million from the Province of Nova Scotia of which Utility Group's proportionate share is $1.9 million. Of the total loan proceeds, $2.0 million (Utility Group's share – $0.5 million) was forgiven upon achieving certain capital investments. A corresponding $2.0 million reduction (Utility Group's share – $0.5 million) in property, plant and equipment was recorded. The loan from the Province of Nova Scotia is currently non-interest bearing. If prescribed revenue targets are achieved, interest will accumulate on a prospective basis at a rate of 6 percent. The loan continues to be guaranteed on a proportionate basis of ownership by the shareholders of Heritage Gas. On or before July 31, 2011 Heritage Gas will elect to repay the loan in one lump sum payment on July 1, 2014, or in five equal instalment payments beginning July 31, 2012. Heritage Gas may also elect to fully repay the loan at any time with no penalty.

10. SHARE CAPITAL

Authorized

- An unlimited number of common shares without nominal or par value; and
- An unlimited number of preferred shares without nominal or par value, issuable in series, to which the directors may fix before issuance the designation, rights, privileges, restrictions and conditions to attach to the preferred shares of each series.

Issued and Outstanding

	Number	Amount
Common shares issued on formation	10	$ –
Issued in exchange for all of the shares of AUHI	7,799,895	58,500
Issued on public offering	390,000	2,925
Share issue costs (net of tax)	–	(147)
Shares outstanding at December 31, 2005	8,189,905	$ 61,278
Shares outstanding at December 31, 2006	**8,189,905**	**$ 61,278**

On November 17, 2005 in conjunction with the Trust's spin-out of its Natural Gas Distribution segment into a separate, publicly traded company, Utility Group issued 7,799,895 common shares to a subsidiary of the Trust for all of the shares of AUHI. The fair market value of the shares issued was $58.5 million and there were no costs of issuance.

On November 17, 2005 Utility Group closed a public offering for 390,000 common shares at $7.50 per share. Proceeds net of share issue costs were $2.7 million.

Net Income Per Share

	2006	2005
Weighted-average shares outstanding – basic	**8,189,905**	8,189,905
Dilutive effect of potential exercise of stock options	**12,390**	9,613
Weighted-average shares outstanding – diluted	**8,202,295**	8,199,518

The potential exercise of stock options had no dilutive effect for the period ended December 31, 2005.

For 2005, net income per share was calculated using the weighted-average number of shares outstanding from the period November 17 to December 31, 2005 as there was no operating income prior to November 17, 2005.

Stock Option Plan

Utility Group has an employee stock option plan under which both employees and directors are eligible to receive grants. At December 31, 2006, 818,990 shares (2005 – 818,990) were reserved for issuance under the plan. To December 31, 2006 options granted under the plan had a term of 10 years to expiry and vested no longer than over a four-year period.

During 2006 Utility Group granted 150,500 options at prices ranging from $6.82 to $8.06 (2005 – 170,000 at $7.50) and cancelled 10,000 options priced at $7.50. At December 31, 2006 outstanding options are exercisable to the year 2016 (2005 – 2015). Stock options outstanding have a weighted average remaining term of 9.34 years (2005 – 9.88 years). Stock option compensation expense charged to operating and administrative expense for the year ended December 31, 2006 was $0.3 million (2005 – $7,000), with a corresponding increase in contributed surplus.

	2006		2005	
	Number of options	Weighted average exercise price	Number of options	Weighted average exercise price
Stock options outstanding, beginning of period	**170,000**	**$ 7.50**	–	$ –
Granted	**150,500**	**6.98**	170,000	7.50
Cancelled	**(10,000)**	**7.50**	–	–
Stock options outstanding, end of period	**310,500**	**$ 7.25**	170,000	$ 7.50
Exercisable at end of period	**80,000**	**$ 7.50**	–	$ –

The fair value of each option granted is estimated on the date of grant using the Black-Scholes option pricing model with weighted-average assumptions for grants as follows:

	2006	2005
Risk-free interest rate (percent)	**3.87 – 4.31**	4.08
Expected lives (years)	**10**	10
Expected volatility (percent)	**14.26**	14.00
Annual dividends per share (dollars)	**0.12**	–

11. COMMITMENTS

Lease Agreements

Utility Group has future minimum lease payments under operating leases for office and warehouse space, office equipment and automotive equipment, estimated as follows:

2007	$ 93
2008	$ 80
2009	$ 48
2010	$ 2
2011	$ 2

Natural Gas Supply

Inuvik Gas purchases gas for resale from the Ikhil Joint Venture under a 15-year gas purchase agreement at a price adjusted annually on August 1 based on the change in the average price of high sulphur diesel at Edmonton. This arrangement is the sole source of Inuvik Gas' gas supply.

12. INCOME TAX

The tax provision recorded in the consolidated financial statements differs from the amount computed by applying the combined Canadian federal and provincial statutory income tax rates to income before income taxes as follows:

	2006	2005
Income before income taxes	$ 5,230	$ 1,616
Statutory income tax rate	32.9%	33.62%
Expected taxes at statutory rate	1,720	543
Increase (decrease) in income taxes resulting from:		
Depreciation and amortization less than capital cost allowance claimed for income tax purposes	150	(14)
General and administrative expenses capitalized	(840)	(93)
Interest expense capitalized	(57)	–
Large Corporations Tax in excess of federal surtax	–	46
Compensation expense not deductible for tax purposes	63	2
Other	(36)	(87)
Provision for income taxes		
Current	989	397
Future	11	(50)
	$ 1,000	$ 347
Effective income tax rate	19.12%	21.47%

Future income tax expense and future income tax assets and liabilities have not been recognized for Utility Group's rate regulated businesses. The unrecognized future income tax benefit for the year ended December 31, 2006 was $0.8 million (2005 – expense of $0.2 million). Unrecognized future income tax liabilities at December 31, 2006 were $5.8 million (2005 – $7.0 million).

Future income taxes recognized in these financial statements comprise the following:

	2006	2005
Future income tax liability – property, plant and equipment	$ 99	$ 119
Future income tax asset – unfunded pension obligation and unamortized issue costs	(103)	(133)
Less amounts included in current future income tax assets	(16)	(133)
	$ (87)	$ –

13. NET CHANGE IN NON-CASH WORKING CAPITAL

The net change in the following non-cash working capital items increased (reduced) cash flows from operations as follows:

	2006	2005
Accounts receivable	**$ 3,602**	$ (4,986)
Inventory, prepaid expenses and deferred charges	**(104)**	(605)
Accounts payable and accrued liabilities	**(4,266)**	5,172
Deferred cost of gas, net of income taxes	**494**	(2,562)
Income and other taxes payable	**(69)**	(1,807)
	(343)	(4,788)
Decrease in capital costs receivable	**(145)**	–
Increase in capital costs payable	**(1,396)**	128
Net change in non-cash working capital related to operations	**$ (1,884)**	$ (4,660)

The following cash payments have been included in the determination of net income:

	2006	2005
Interest paid	**$ 3,360**	$ 9
Income taxes paid	**$ 1,093**	$ 36

14. PENSION AND OTHER RETIREMENT BENEFIT PLANS

Substantially all full-time employees of Utility Group's subsidiary AUI are members of defined benefit non-contributory pension plans. The defined benefit pension plans are funded by contributions by AUI. Pension benefits are based on length of service and final average earnings. Cash payments of $1.1 million were made to fund the pension plans by AUI during the year (2005 – $0.2 million). These plan contributions were made in accordance with the Report on the Actuarial Valuation for Funding Purposes as at September 30, 2005, dated March 29, 2006 for each plan. The next actuarial valuations for funding purposes must be no later than September 30, 2008.

AUI also has plans that provide other post-retirement benefits such as life insurance and health care to certain of its employees. These other benefit plans are not funded.

On January 1, 2006 Utility Group established a defined contribution pension plan for substantially all full-time employees of its corporate office.

Effective January 1, 2006 Utility Group established a non-registered, unfunded, defined benefit retirement plan that provides pension benefits to eligible executives based on average earnings, years of service and age at retirement (supplemental executive retirement plan (SERP)). There is one executive eligible for benefits under this plan. The SERP benefits will be paid from the general revenue of Utility Group as payments become due. Security will be provided for the SERP benefits through a letter of credit held in a Retirement Compensation Arrangement Trust account.

As part of the spin-out of Utility Group from the Trust, effective January 1, 2006 Utility Group assumed the Trust's liability to the Chief Executive Officer (CEO) of Utility Group for the CEO's benefits earned under the Trust's SERP. The Trust paid Utility Group $0.5 million, representing the total estimated liability for service credited to January 1, 2006, and the potential liability for additional past service yet to be credited related to the CEO's period of employment with the Trust.

The net pension expense recorded for the year was:

	2006	2005
AUI defined benefit plans	$ 1,113	$ 112
SERP defined benefit plan	105	–
Defined contribution plan	24	–
Other benefit plans	229	22
	$ 1,471	$ 134

The following table summarizes the details of the defined benefit and SERP plans:

	2006		2005	
	Defined benefit pension plans	Other benefit plans	Defined benefit pension plans	Other benefit plans
Accrued Benefit Obligation				
Balance, beginning of period	$ 17,081	$ 1,770	$ 16,147	$ 1,675
Accrued benefit obligation assumed	299	–	–	–
Actuarial loss (gain)	(1,030)	(79)	732	82
Current service cost	1,216	69	101	7
Interest cost	912	91	110	9
Benefits paid	(270)	(28)	(9)	(3)
Balance, end of period	$ 18,208	$ 1,823	$ 17,081	$ 1,770
Fair Value of Plan Assets				
Balance at beginning of period	$ 14,476	$ –	$ 14,171	$ –
Actual return on plan assets	1,402	–	81	–
Employer contributions	1,111	28	233	3
Benefits paid	(270)	(28)	(9)	(3)
Fair value of plan assets at end of period	$ 16,719	$ –	$ 14,476	$ –
Funding Deficit	$ (1,489)	$ (1,823)	$ (2,605)	$ (1,770)
Unamortized transitional obligation	184	647	371	301
Unamortized past service costs	72	–	105	–
Unamortized net actuarial loss	1,348	271	2,859	765
Accrued benefit asset/(liability)	$ 115	$ (905)	$ 730	$ (704)

The current portion of the accrued benefit asset (liability) is included in accounts payable and accrued liabilities and the non-current portion is included in other liabilities.

	2006		2005	
Significant Actuarial Assumptions Used as at December 31 (percent)	Defined benefit pension plans	Other benefit plans	Defined benefit pension plans	Other benefit plans
Discount rate	**5.0 – 5.3**	**5.0 – 5.3**	6.0	6.0
Expected long-term rate of return on plan assets	**6.8**	**n/a**	6.5	n/a
Rate of compensation increase	**4.0**	**4.0**	5.0	5.0
Average remaining service life of active employees (years)	**14**	**16**	14	16
Net Benefit Plan Expense for the Year				
Current service cost and expenses	**$ 1,216**	**$ 69**	$ 101	$ 7
Interest cost	**912**	**91**	110	9
Actual return on plan assets	**(1,402)**	**–**	(81)	–
Actuarial losses (gains)	**(1,030)**	**(79)**	732	82
Costs arising in the period	**$ (304)**	**$ 81**	$ 862	$ 98
Differences Between Costs Arising in the Period and Costs Recognized in the Period in Respect of:				
Return on plan assets	**404**	**–**	(27)	–
Plan amendments	**33**	**–**	4	–
Actuarial loss (gain)	**1,107**	**118**	(733)	(80)
Transitional obligations	**(22)**	**30**	6	4
Net periodic benefit plan costs recognized	**$ 1,218**	**$ 229**	$ 112	$ 22

The estimates for health care benefits take into consideration increased health care benefits due to aging and cost increases in the future. The assumed initial health care cost trend rates used to measure the expected cost of benefits is 8.0 percent and the ultimate trend rate is 5.0 percent, which is assumed to be achieved by 2011.

Assumed health care cost trend rates have a significant effect on the amounts reported for the health care plans. A one-percentage-point change in the assumed health care cost trend rates would have the following effects for 2006:

	Increase	Decrease
Total service and interest cost	**$ 36**	**$ (27)**
Accrued benefit obligation	**$ 350**	**$ (272)**

15. RELATED PARTY TRANSACTIONS

In the normal course of business, Utility Group and its affiliates transact with related parties. The following related party transactions are measured at their exchange amounts:

	2006	2005
Fees for administration, management and other services paid by:		
Utility Group to the Trust	$ 30	$ 4
The Trust to Utility Group	$ 505	$ –
The Trust to AUI	$ 34	$ 6
Ikhil Joint Venture to Inuvik Gas	$ 461	$ 46
Fees for operating services paid by AUI to the Trust	$ 469	$ 117
Gas purchases for resale by Inuvik Gas from the Ikhil Joint Venture *(note 11)*	$ 1,174	$ 198
Transportation services provided by AUI to the Trust	$ 560	$ 98
Gas purchases for resale by AUI from the Trust	$ 82,872	$ 25,644

The resulting amounts due from and to related parties are non-interest bearing and are related to transactions in the normal course of business.

Included in accounts receivable at December 31, 2006 is $0.7 million (December 31, 2005 – $0.2 million) due to Utility Group from the Trust.

Included in accounts payable and accrued liabilities at December 31, 2006 is $13.8 million (December 31, 2005 – $21.0 million) due from Utility Group to the Trust.

16. JOINT VENTURES

Utility Group's proportionate interest in its joint venture arrangements is summarized as follows:

Proportionate Share of Net Assets	2006	2005
Current assets	$ 1,572	$ 1,211
Property, plant and equipment	14,392	9,846
Deferred charges	94	75
Revenue deficiency account	2,568	1,346
Current liabilities	(1,810)	(1,222)
Long-term debt	(9,058)	(6,231)
Other liabilities	(104)	–
	$ 7,654	$ 5,025

Proportionate Share of Net Income	2006	2005
Revenue	$ 2,498	$ 657
Expenses	(1,713)	(585)
	$ 785	$ 72

Proportionate Share of Cash Flows	2006	2005
Operating activities	$ (1,159)	$ 194
Investing activities	(3,728)	(857)
Financing activities	4,802	597
	$ (85)	$ (66)

17. SEASONALITY

The natural gas distribution business is highly seasonal, with the majority of natural gas deliveries occurring during the winter heating season. Gas sales during the winter typically account for approximately two-thirds of annual revenue, resulting in strong first and fourth quarter results and losses in the second and third quarters.

18. SUBSEQUENT EVENTS

On January 8, 2007 Utility Group purchased an additional 270,412 common shares of Heritage Gas for $0.3 million and advanced $0.3 million under its long-term loan agreement.

On February 22, 2007 Utility Group purchased an additional 234,395 common shares of Heritage Gas for $0.2 million and advanced $0.5 million under its long-term loan agreement.

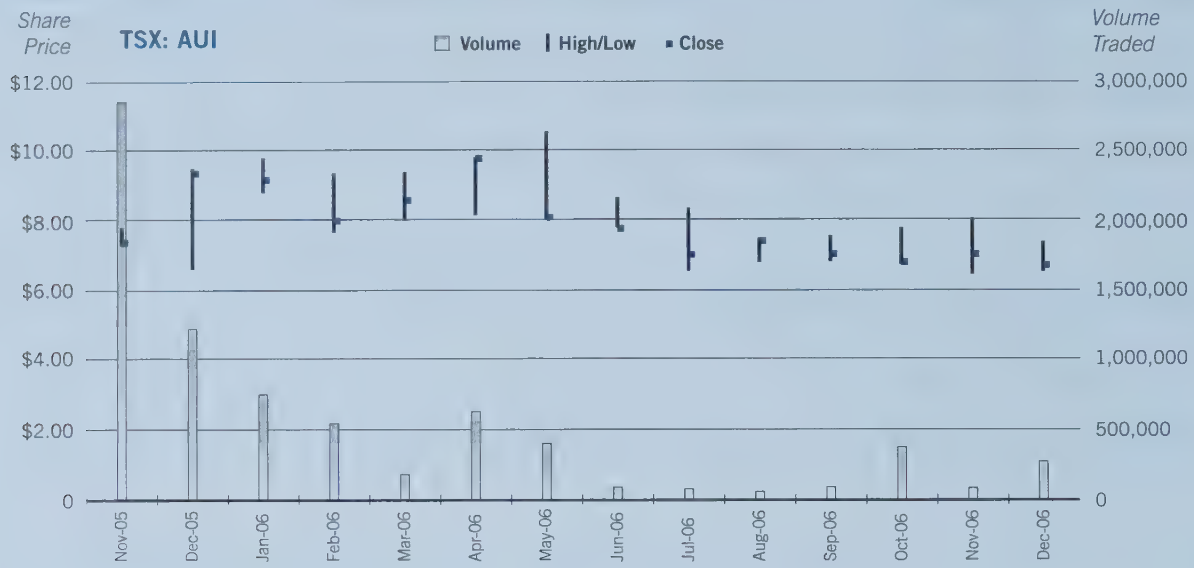
Contributions were also made by the other shareholders of Heritage Gas, resulting in no change to Utility Group's proportionate ownership interest in Heritage Gas.

19. COMPARATIVE FIGURES

Certain comparative figures have been reclassified to conform to current financial statement presentation.

Shareholder Information

SHARE TRADING HISTORY



2005 High – $9.44 **Low** – $6.56 **Close** – $9.35 | **2006 High** – $10.48 **Low** – $6.40 **Close** – $6.67

DIVIDENDS ON COMMON SHARES

Declaration Date	Record Date	Payment Date	Type	Amount
2006				
March 16, 2006	March 31, 2006	April 17, 2006	Cash	$ 0.03
May 4, 2006	June 30, 2006	July 17, 2006	Cash	$ 0.03
August 2, 2006	September 29, 2006	October 16, 2006	Cash	$ 0.03
November 11, 2006	December 29, 2006	January 15, 2007	Cash	$ 0.03
2006 Total				**$ 0.12**
2007				
February 28, 2007	March 30, 2007	April 16, 2007	Cash	$ 0.035

Future payments of dividends will depend upon Utility Group's financial condition, capital requirements and earnings, as well as other factors the Board of Directors may deem relevant.

Officers

Patricia M. Newson, CA
President and Chief Executive Officer

Patricia Newson has served as Chief Executive Officer of AltaGas Utility Group Inc. since its inception in July 2005. She joined AltaGas Income Trust (then AltaGas Services Inc.) as Vice President Finance and Chief Financial Officer in 1996 and was Senior Vice President Finance and Chief Financial Officer from 1998 to May 2006. Ms. Newson continues to hold the position of Senior Vice President at the Trust. She led organizational and process changes as AltaGas Income Trust grew from 20 employees to 600, and evolved from a private corporation to a $1.6 billion market capitalization public income trust.

Since it was acquired by AltaGas Income Trust in 1998, Ms. Newson has been a member of the Board of Directors and the Treasurer of AltaGas Utilities Inc. She is Utility Group's shareholder representative on the Shareholder Committee of Heritage Gas Limited and is on the Board of Directors of Inuvik Gas Ltd. Ms. Newson has also been on the Board of Directors of the Canadian Gas Association since May 2006.

Prior to joining AltaGas Income Trust, Ms. Newson acted as Manager Strategic Planning at BC Hydro and Power Authority and spent several years as an independent consultant to many businesses including BC Hydro, BC Gas Ltd., and the Crown Corporation Secretariat of British Columbia.

Ms. Newson's energy industry experience spans more than 25 years and includes corporate and regulatory reporting during several restructurings with Gulf Canada, GW Utilities and Olympia and York Enterprises. Ms. Newson holds a B.Comm. (distinction) in accounting and has been a member of the Institute of Chartered Accountants of Alberta for more than 25 years.

Dimitrios (Jim) Leonidas, CA
Chief Financial Officer and Corporate Secretary

Jim Leonidas has served as Chief Financial Officer and Corporate Secretary of AltaGas Utility Group Inc. since December 4, 2006. He is also a member of the Board of Directors of AltaGas Utilities Inc.

From July 2004 to December 2006, Mr. Leonidas was Executive Vice President and Chief Financial Officer of AltaLink Management Ltd., a SNC Lavalin subsidiary. During his tenure Mr. Leonidas led the restructuring of the partnership, the issuance of $350 million in long-term investment-grade debt, the placement of a $500 million shelf prospectus and the successful implementation of CEO/CFO certification.

At SNC Lavalin he worked in many aspects of international finance and operations and facilitated projects in Asia, Europe, North and South America, progressing to the position of Vice President and General Manager of Securiplex, a SNC Lavalin subsidiary within the defense and oil and gas industries.

Prior to seven years in progressive accounting, controllership and finance positions, Mr. Leonidas began his career in the audit department of Coopers & Lybrand. He is a chartered accountant who holds a Bachelor of Science Degree in Agricultural Engineering from McGill University, a graduate diploma in Public Accountancy from Concordia University and is a member of the Institutes of Chartered Accountants of Ontario and Alberta.

Corporate Information

BOARD OF DIRECTORS

David W. Cornhill[(1)(2)]
Chairman and Director

Dennis A. Dawson[(1)(2)(3)(4)]
Director

Phillip R. Knoll[(1)(2)(4)]
Director

Gerry M. Malin[(1)(2)(3)]
Director

Patricia M. Newson, CA[(3)]
President, Chief Executive Officer and Director

J. Bruce Petrie, CA[(1)(2)(4)]
Director

[1] Independent Director.

[2] Human Resources and Compensation Committee.

[3] Environment, Occupational Health and Safety Committee.

[4] Audit and Governance Commitee.

ANNUAL MEETING

Utility Group's Board of Directors and Management team invite all Utility Group shareholders to attend the annual meeting to be held on Wednesday, April 18, 2007 at 3:00 p.m. MDT at the Royal Room in The Metropolitan Centre, 333-4th Avenue S.W., Calgary, Alberta.

AUDITORS

Ernst & Young LLP
Calgary, Alberta

TRANSFER AGENT

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